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Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-927

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM, *Petitioner*

v.

INVESTMENT COMPANY INSTITUTE, *Respondent*

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

COUNTERSTATEMENT OF THE QUESTION PRESENTED

Whether the Glass-Steagall Act, as construed by this Court in *Investment Company Institute* v. *Camp*, 401 U.S. 617 (1971), and the Bank Holding Company Act, as amended, forbid the Federal Reserve Board to authorize banks and their holding company affiliates to sponsor closed-end investment companies as vehicles for the issuance and marketing of securities to the general public.

COUNTERSTATEMENT OF THE CASE

Introductory Statement

This case presents the latest effort in a 20-year campaign by segments of the United States banking industry, often aided by its federal regulators, to gain access to a line of business from which banks and their affiliates were excluded by an act of Congress nearly half a century ago—the sponsorship, organization, management, and control of investment companies as vehicles for the marketing of securities to the general public.

The Camp Decision

On April 5, 1971, in *Investment Company Institute* v. *Camp,* 401 U.S. 617 (1971), this Court concluded that the Banking Act of 1933, popularly known as the Glass-Steagall Act, precludes national banks from sponsoring investment companies—that is, companies set up as investment vehicles to offer their own securities to the general public and to use the proceeds to purchase securities for their portfolios. Overturning a 1962 regulation of the Comptroller of the Currency that purported to authorize such activity, the Court ruled that a bank's "operation of an investment fund of the kind approved by the Comptroller involves [the] bank in the underwriting, issuing, selling, and distributing of securities in violation of §§ 16 and 21 of the Glass-Steagall Act." 401 U.S. at 639.

The Court's ruling in *Camp* was based upon a thorough review of the legislative history of the Glass-Steagall Act, and in particular the congressional determination to divorce commercial banking on the one hand from the issuance and marketing of securities on the other in light of the banking crisis of the early

1930s that had been brought on in large measure by the intertwining of those two lines of commerce.

The Board's Proposed Regulation

Fewer than five months after the *Camp* decision, on August 12, 1971, the petitioner, Board of Governors of the Federal Reserve System (hereafter the "Board") proposed an amendment to its Regulation Y, purportedly promulgated under the Bank Holding Company Act Amendments of 1970. Specifically, the Board announced that it proposed to amend Section 222.4(a) of Regulation Y to permit bank holding companies to serve as investment advisers to investment companies.[1]

In response to the Board's notice, the Investment Company Institute (the "Institute"), a trade association of investment companies, submitted several memoranda and the affidavit of its president in opposition to the proposed amendment (R. 7-63).

The Final Regulation and Interpretive Ruling

On January 28, 1972, following an informal hearing, the Board promulgated the final version of its amend-

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[1] The text of the proposed amendment read pertinently:

"§ 222.4 *Nonbanking Activities.*

"(a) ***Activities closely related to banking or managing or controlling banks.*** * * * The following activities have been determined by the Board to be so closely related to banking or managing or controlling banks as to be a proper incident thereto:

* * *

"(5) Acting as investment or financial adviser, including (i) serving as the advisory company for a mortgage or a real estate investment trust; (ii) ***serving as investment adviser to an investment company registered under the Investment Company Act of 1940;*** and (iii) furnishing economic or financial information." 36 Fed. Reg. 16695 (Aug. 25, 1971), as amended, 36 Fed. Reg. 17514 (Sept. 1, 1971) (Pet. App. 4a) (emphasis supplied).

ment to Regulation Y.[2] Accompanying the revised Regulation Y was an Interpretive Ruling of the Board, published at 37 Fed. Reg. 1464 (1972), relating to the scope of the activity described in the regulation (Pet. App. 83a). The Interpretive Ruling itself was codified as Section 225.125 of Regulation Y (12 C.F.R. § 225.125).

At the outset, the Board conceded that "it is clear from the legislative history of the Bank Holding Company Act Amendments of 1970 . . . that the Glass-Steagall Act provisions were not intended to be affected thereby." Accordingly, the Board stated that it regarded "the Glass-Steagall provisions and the Board's prior interpretations thereof as applicable to a holding company's activities as an investment adviser." Section 225.125(b).

The Board then declared that under its revised regulation, bank holding companies were defined to include "*both their bank* and nonbank *subsidiaries*" (emphasis supplied). As so defined, such holding companies were authorized by the Board to "act as investment advisers to *various types* of investment com-

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[2] That amen nent, in pertinent part, revised the operative provision in Section 225.4(a)(5)(ii) (the underscored material in footnote 1 above) to read as follows:

> "serving as investment adviser, as defined in § 2(a)(20) of the Investment Company Act of 1940, to an investment company under that Act . . . ." 37 Fed. Reg. 1463; 12 C.F.R. § 225.4(a)(5)(ii) (Pet. App. 81a).

The effect of the Board's revision, incorporating the provision of the 1940 Act referred to, was to bring into play that Act's definition of an "investment adviser" as any person who, pursuant to contract with the investment company, regularly furnishes investment advice, or has the power to make determinations with respect to portfolio purchases and sales. 15 U.S.C. § 80a-2(a)(20).

panies" (emphasis supplied), including both open-end investment companies, commonly referred to as mutual funds, and closed-end investment companies. Section 225.125(c).

The Board next announced its view that "a bank holding company may exercise all functions that are permitted to be exercised by an 'investment adviser' under the Investment Company Act of 1940 . . . ." Section 225.125(d). The Board acknowledged that, as a matter of industry custom and practice, investment advisers to investment companies registered under the Investment Company Act do far more than merely advise their investment companies as to portfolio purchases and sales. Rather, the Board recognized, "presently most mutual funds are organized, sponsored and managed by investment advisers with which they are affiliated and . . . their securities are distributed to the public by such affiliated investment advisers, or subsidiaries or affiliates thereof." Section 225.125(e).

The Board stated its opinion that "the Glass-Steagall Act provisions, as interpreted by the U.S. Supreme Court, forbid a bank holding company to sponsor, organize or control a mutual fund"—that is, an *open*-end investment company. Section 225.125(f). However, the Board stated its disbelief that "such restrictions apply to closed-end investment companies as long as such companies are not primarily or frequently engaged in the issuance, sale and distribution of securities." *Id.* The Board thereupon proposed a series of restrictions upon bank holding company sponsorship, organization, and control of closed-end investment companies which, in its view, would enable participating entities to avoid a violation of Glass-Steagall.

Taken as a whole, the Board's Regulation and accompanying Interpretive Ruling sanctioned a wide degree of involvement on the part of bank holding companies and their subsidiaries in virtually all phases of closed-end investment company activities—the organization of the funds, their management, discretionary control of their portfolio purchases and sales, and (except as restricted in the Interpretive Ruling) their marketing and promotion. In its Ruling, the Board referred to the practice of the investment company industry whereby the fund adviser conventionally organizes, sponsors, and manages the fund with which it is affiliated. Section 225.125(e); *cf.* A. 13-15 (submission of Justice Department). The court of appeals below spoke of the "sponsoring, organizing, managing, or controlling [of] such companies." *Investment Company Institute* v. *Board of Governors of the Federal Reserve System,* 606 F.2d 1004, 1009 n.13 (Pet. App. 8a). Before this Court, the Board has characterized its Regulation and Interpretive Ruling as leaving the bank holding company "free to organize and manage the client investment company, to select its investments, and to provide ancillary services" (Pet. Br. 29 n.21). In this Brief, we shall refer collectively to all such activities sanctioned by the Board as the "sponsorship" of the investment company, which it is apparent that the Board has intended to authorize to bank holding companies and their subsidiaries, banking and nonbanking alike.

The Institute's First Petition

On December 12, 1973, the Institute petitioned the Board to reconsider and rescind the Regulation. An affidavit submitted in support of the petition demon-

strated that as of its date, at least 16 closed-end investment companies were organized, controlled and advised by banks and bank-affiliated institutions, and that of those 16, at least 10 were advised by the *banks* affiliated with the holding companies concerned (R. 338-50). A number of sponsoring banks specifically referred to the Regulation as authorizing their sponsorship of closed-end investment companies. *See* pp. 14-15 *infra.*

On March 8, 1974, the Board denied the Institute's petition in a letter addressed to the Institute's counsel (Pet. App. 53a). *First,* the Board rejected the Institute's contention that the Regulation sanctioned activity in violation of Glass-Steagall Act Section 21. The Board asserted that "the prohibitions of Section 21 apply only to a bank and may not be held applicable to a bank holding company or a nonbank subsidiary of a bank holding company" (Pet. App. 56a).

Second, the Board conceded that "some of the same dangers cited by the United States Supreme Court in *ICI* v. *Camp* . . . may also be present with respect to the conduct of investment advisory activities" (Pet. App. 57a). However, the Board purported to discover "several significant distinctions" between the investment fund that this Court had found unlawful in *Camp* and the activity authorized by the amended Regulation Y. The Board's distinction turned essentially upon the asserted facts that under the Regulation bank holding companies were prohibited to engage in the actual offering and sale of investment company securities, and further that closed-end funds generally are characterized by an absence of continuous selling activity.

Third, the Board denied that its Regulation authorized bank sponsorship of investment companies in violation of Glass-Steagall Section 16. Here the Board asserted that its definition of "bank holding company" to include banking as well as nonbanking subsidiaries amounted to a restriction upon the grant of authority contained in the revised Regulation, and that the authorizations set forth in the accompanying Interpretive Ruling "were only intended to apply where the investment advisory function was being conducted by a nonbanking subsidiary of the bank holding company" (Pet. App. 61a). Thus, the Board concluded, any bank sponsorship of an investment company purportedly in reliance upon the Regulation and Interpretive Ruling could not in fact be activity pursuant to the Regulation. *Id.* Nonetheless, as the primary federal supervisory agency for state member banks of the Federal Reserve System, the Board specifically held that, consistently with Glass-Steagall, a bank could purchase securities for investment funds that it sponsored, on the theory that an investment company created and controlled by the bank could be deemed its "customer" within the meaning of Glass-Steagall Section 16 (Pet. App. 62a-63a).

On May 8, 1974, the Institute commenced a civil action against the Board and its individual members in the United States District Court for the District of Columbia. The Institute's complaint sought a declaratory judgment and injunctive and other relief. Various evidentiary materials, including affidavits, were received by the district court in connection with cross-motions for summary judgment.

On July 30, 1975, the district court entered an order dismissing the complaint on the ground that review of

the Board's action properly should be sought in the first instance in the court of appeals pursuant to Section 9 of the Bank Holding Company Act. *Investment Company Institute* v. *Board of Governors of the Federal Reserve System,* 398 F. Supp. 725 (D.D.C. 1975). On January 14, 1977, the United States Court of Appeals for the District of Columbia Circuit affirmed the district court's jurisdictional ruling. However, the court of appeals granted leave to the Institute to file a fresh petition for reconsideration before the Board and to prosecute a petition for review in an appropriate court of appeals should the Board deny that petition. *Investment Company Institute* v. *Board of Governors of the Federal Reserve System,* 551 F.2d 1270 (1977).

The Institute's Second Petition

On March 18, 1977, the Institute filed a renewed petition before the Board in accordance with the decision of the court of appeals, requesting that the Board reconsider and rescind the Regulation (R. 2696). The renewed petition incorporated by reference the evidentiary materials submitted in support of the first petition, and offered supplemental evidence by affidavit. In the aggregate, those evidentiary materials demonstrated the active involvement of both banks and bank affiliates in the sponsorship of investment companies, as well as the participation of such banking institutions in the underwriting and public sale of the securities issued by investment companies.

On August 31, 1977, the Board by order denied the Institute's renewed petition (Pet. App. 65a). Again, the Board refused to consider the Institute's evidentiary showing that banks, as well as bank holding

companies and nonbanking affiliates, were engaged in the sponsorship of investment companies, on the purported ground that such conduct could not be deemed sanctioned by the Board's Regulation (Pet. App. 67a-68a).

On September 23, 1977, the Institute initiated the present judicial proceeding by filing a petition for review before the United States Court of Appeals for the District of Columbia Circuit. By judgment entered March 30, 1979, that court vacated the Regulation and Interpretive Ruling. 606 F.2d 1004 (Pet. App. 50a). After rejecting the Board's threshold challenge to the standing of the Institute to maintain the petition for review, 606 F.2d at 1010-11 (Pet. App. 12a-14a), the court analyzed the applicable statutory schemes. The court concluded that it was unnecessary to determine whether any particular provision of the Glass-Steagall Act operated to invalidate the Regulation and Interpretive Ruling. In the court's view, the Bank Holding Company Act, as amended, pursuant to which the Board purportedly had acted, did not authorize the promulgation of the Regulation and Interpretive Ruling under attack.

The Board petitioned for rehearing and suggested a rehearing *en banc*. After the court of appeals denied those applications (Pet. App. 51a), the present petition for certiorari followed.

SUMMARY OF ARGUMENT

I.

The Regulation promulgated by the Board, together with its Interpretive Ruling, violates the prohibition of the Glass-Steagall Act against the involvement of

the banking industry in the issuance and marketing of securities to the general public. The Regulation and Interpretive Ruling permit the sponsorship by banks of closed-end investment companies, despite the plain prohibition contained in Sections 16 and 21 of the Glass-Steagall Act, as interpreted by this Court in *Investment Company Institute* v. *Camp, supra.* The evidence submitted by the Institute to the Board below demonstrated that banks in fact are relying upon the Regulation and Interpretive Ruling to engage in the prohibited activities.

The ostensible justification offered by the Board for its departure from *Camp*—that that case dealt only with the equivalent of an open-end fund, whereas here the Board has permitted bank involvement in closed-end funds—is without material significance. The functional similarities of closed- and open-end funds outweigh their differences, and the prohibitions contained in Glass-Steagall plainly apply to investment companies of both categories.

II.

The Bank Holding Company Act, as amended, provides no statutory authority to the Board to authorize activities by bank holding companies that are prohibited to banks by the Glass-Steagall Act. Neither the Bank Holding Company Act of 1956, nor the 1966 and 1970 amendments to that Act, have displaced the fundamental statutory bar erected by Glass-Steagall to the banking industry's involvement in securities issuance and marketing. The legislative history of the 1970 amendments to the Bank Holding Company Act makes clear that Congress never contemplated that the Board would have the authority to find that the

sponsorship of closed-end investment companies is a function, in the words of the statute, "so closely related to banking . . . as to be a proper incident thereto . . . ."

As a matter of law, bank holding company sponsorship of closed-end investment companies cannot meet the test prescribed by the Bank Holding Company Act. *First,* because such sponsorship affirmatively is prohibited to banks under Glass-Steagall, it cannot be deemed "a proper incident" of banking for purposes of the Bank Holding Company amendments. *Second,* because the sponsorship of closed-end investment companies would depart from accepted and traditionally circumscribed fiduciary functions of banks, as recognized by the Board in numerous past rulings, such sponsorship likewise cannot be deemed "a proper incident" within the meaning of the 1970 amendments.

III.

The Regulation and Interpretive Ruling are invalid insofar as they authorize the sponsorship of closed-end investment companies by bank holding companies. As in the case of banks, such sponsorship violates the Glass-Steagall Act, as is apparent from a review of the overall statutory scheme and of the particular statutory provisions that relate to bank affiliate involvement in securities marketing. The abstinence of the banking industry from the sponsorship of investment companies in the years following enactment of Glass-Steagall demonstrates the industry's awareness that the Act effectively foreclosed securities flotation and distribution as a line of commerce for both banks and their holding company affiliates.

The Board purports to recognize the import of Glass-Steagall and this Court's interpretation in *Camp,* but its Regulation and Interpretive Ruling do little more than pay lip service to those principles. The Ruling, which ostensibly narrows the scope of permitted activity by bank holding companies in their sponsorship of closed-end investment companies, disregards Congress' intention in Glass-Steagall to fashion a prophylactic statute that would leave no room for the exercise of administrative discretion. The Ruling also fails to address many of the central concerns that were voiced both by the authors of Glass-Steagall at the time of its enactment and by this Court in *Camp* when it reviewed the history of that legislation.

ARGUMENT

I. THE BOARD'S REGULATION AND INTERPRETIVE RULING VIOLATE THE GLASS-STEAGALL ACT IN THAT THEY PURPORT TO SANCTION BANK SPONSORSHIP OF CLOSED-END INVESTMENT COMPANIES

A. The Regulation and Interpretive Ruling Permit Bank Sponsorship of Investment Companies

On their face, the Board's Regulation and Interpretive Ruling purport to authorize banks, as well as bank holding companies and their nonbank subsidiaries, to sponsor closed-end investment companies. The Interpretive Ruling states that the term "bank holding companies" includes "both their *bank* and non-bank subsidiaries," 12 C.F.R. § 225.125(c) (emphasis supplied); that "the Glass-Steagall Act provisions, as interpreted by the U.S. Supreme Court, forbid a bank holding company to sponsor, organize or control a mutual fund," *id.* § 225.125(f); but that "the Board

does not believe that such restrictions apply to closed-end investment companies," *id.* The plain meaning of the Interpretive Ruling is that both banks, on the one hand, and bank holding companies and nonbank subsidiaries, on the other, may engage in the sponsorship of closed-end funds. The Board has confirmed this interpretation of its Ruling by its March 8, 1974 ruling denying the Institute's petition for reconsideration and rescission. There, in its role as supervisory agency for state member banks, the Board specifically concluded that banks may sponsor closed-end funds.

The banking industry has taken the Board at its word. Following promulgation of the Regulation and Ruling, numerous national and state banks, for the first time since the passage of Glass-Steagall, began to involve themselves in the organization and operation of closed-end investment companies. Less than a month after promulgation of the Regulation, Independence Square Income Securities, Inc., one of the investment companies advised directly by Provident National Bank (Philadelphia) stated in its prospectus: "To the knowledge of Provident, the Fund will be the first closed-end investment company, the securities of which are publicly traded, for which a national bank acts as investment adviser" (R. 2420).

The banks acted in direct reliance upon the Board's Regulation. This is evident from the registration statements filed with the SEC by a number of the closed-end investment companies advised directly by banks. A good example appears in the prospectus filed in 1972 by Advance Investors Corporation, a closed-end fund sponsored and managed directly by Citibank

(which earlier had sponsored the fund condemned in *Camp*):

> "In May 1971 the United States Supreme Court in *Investment Company Institute* v. *Camp*, 401 U.S. 617, held that the Glass-Steagall Act prohibits a national bank from operating a fund for the collective investment of managing agency accounts. The fund which was the subject of the litigation was operated by Citibank and was registered as an open-end investment company. . . . Subsequent to such decision, the Board of Governors of the Federal Reserve System ruled that the Glass-Steagall Act and such decision do not prohibit a bank holding company *or any subsidiary* thereof from acting as investment adviser to a registered, closed-end investment company. Citibank is a subsidiary of First National City Corporation, which is a bank holding company registered under the Bank Holding Company Act, and *accordingly Citibank is within the terms of the Board's ruling*" (R. 2305) (emphasis supplied).[3]

Bank activities with respect to closed-end investment companies hardly have been confined to the rendition of

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[3] Similar statements relying upon the Board's Ruling as authority for banks within a bank holding company complex to serve as investment advisers to closed-end investment companies may be found in the S-4 Registration Statements of the following funds: Ben Franklin Income Securities, Inc. (R. 418), advised by Girard Trust Bank (Philadelphia); Bunker Hill Income Securities, Inc. (R. 469), advised by Security Pacific National Bank (Los Angeles); Circle Income Shares, Inc. (R. 666), advised by American Fletcher National Bank & Trust Company (Indianapolis); Overland Income Securities, Inc. (R. 1660), advised by Wells Fargo Bank, National Association (San Francisco); and Pacific American Income Shares, Inc. (R. 1767), advised by a subsidiary of United California Bank.

investment advice to closed-end investment companies. To the contrary, in their sponsorship of closed-end funds, banks have gone to the limit of the apparent authorization contained in the Ruling. In Appendix A to this Brief, we outline the record evidence that demonstrates the pervasive involvement of banks in the sponsorship and management of closed-end funds in reliance on the Board's ruling.

Since the issuance of its Ruling, the Board steadfastly has disclaimed any intention to *authorize* activities to banks under its Ruling. By means of a strained construction of its edict, the Board asserts that the definition of "bank holding company" under its Ruling serves only as a "short-hand method" to impose the *restrictions* of that Ruling upon bank subsidiaries of bank holding companies. Such a position is inconsistent with the Board's March 8, 1974 letter to the Institute. There, in its capacity as federal regulatory supervisor of state member banks, the Board opined that banks lawfully may undertake the activities authorized to holding companies in the Regulation (Pet. App. 61a-63a).

The court of appeals understandably was dubious about the Board's disclaimer of any intention to authorize activities to banks. The court said:

> "Although the Board's explanation of the interpretive ruling is reasonable, it is nevertheless true that *the ruling is highly susceptible to the construction urged by* [*the Institute*]. While that ruling has been published in the Federal Register and the Code of Federal Regulations, the Board's disclaimer has, so far as we know, been circulated only to [the Institute] . . . and to other persons who may have had occasion to read that letter or

> the Board's brief in this review proceeding." 606 F.2d at 1014 (Pet. App. 23a) (emphasis supplied).

Because the court ultimately vacated the Regulation and Ruling on other grounds, it had no occasion to consider what relief might be appropriate to deal with the ambiguity in the Board's draftsmanship.

The banking industry has responded in full measure to the Board's invitation to the industry to immerse itself in the securities business. The 1979 edition of Wiesenberger Investment Companies Service shows the following currently operating closed-end investment companies which were created and sponsored by banking institutions following the Board's Ruling:

Name of Investment Company and Year Organized	Investment Adviser	
Bunker Hill Income Securities, Inc. (1973)	Bank	Security Pacific National Bank, a wholly-owned subsidiary of Security Pacific Corp.
Circle Income Shares, Inc. (1973)	Bank	American Fletcher Nat'l Bank & Trust Co., wholly-owned by American Fletcher Corp.
Current Income Shares, Inc. (1973)	Nonbank subsidiary	Unionamerica Investment Management Co., a wholly-owned subsidiary of Unionamerica, Inc.
Excelsior Income Shares, Inc. (1973)	Bank subsidiary	UST Advisory Co., Inc., a wholly-owned subsidiary of United States Trust Co. of N.Y.
Fort Dearborn Income Securities, Inc. (1972)	Bank	First National Bank of Chicago, a wholly-owned subsidiary of First Chicago Corp.

Name of Investment Company and Year Organized	Investment Adviser	
Hatteras Income Securities (1973)	Bank	N. Carolina National Bank, a wholly-owned subsidiary of N.C.N.B. Corp.
Independence Square Income Securities, Inc. (1972)	Bank	Provident Nat'l Bank, a wholly-owned subsidiary of Provident Nat'l Corp.
Montgomery Street Income Securities (1973)	Nonbank subsidiary	B.A. Investment Mgmt. Corp., a wholly-owned subsidiary of Bank America Corporation
Pacific American Income Shares (1973)	Bank subsidiary	Western Asset Mgmt. Co., a wholly-owned subsidiary of United California Bank, a wholly-owned subsidiary of Western Bancorporation
Vestaur Securities Inc. (1972)	Nonbank subsidiary	First Pennsylvania Corporation, whose principal subsidiary is The First Pennsylvania Banking & Trust Co.

Significantly, five of the 10 investment advisers are *banks,* not their holding companies or other nonbanking affiliates. So far as we are aware, neither the Board nor the Comptroller of the Currency has undertaken enforcement proceedings or opened administrative investigations as to any of the five banks.

B. The Board's Authorization of Bank Sponsorship of Closed-End Investment Companies Violates Sections 16 and 21 of the Glass-Steagall Act as Authoritatively Construed by This Court in Camp

In *Investment Company Institute* v. *Camp,* 401 U.S. 617 (1971), this Court held that Sections 16 and 21 of the Glass-Steagall Act prohibit banks from creating

and operating investment companies. Contrary to the Board's present suggestion (Pet. Br. 31-37), the Court's ruling was not narrowly confined to the lawfulness of bank-sponsored *open*-end funds. Rather, the question before the Court was the lawfulness of *all* bank-sponsored funds, closed- as well as open-end:

> "The issue before us is whether the Comptroller of the Currency may, consistently with the banking laws, authorize a national bank to offer its customers the opportunity to invest in a *stock fund created and maintained by the bank.*" 401 U.S. at 621 (emphasis supplied).

Analysis of the *Camp* decision shows that the Court there precluded what the Board's Regulation and Ruling purport to authorize here—bank sponsorship of closed-end investment companies.

The entity at issue in *Camp* was a plan for the collective investment of managing agency accounts initiated by First National City Bank of New York (now known as Citibank, N.A.). Under the plan a bank customer tendered between $10,000 and $500,000, along with an authorization to the bank to act as the customer's managing agent. In return, the customer received written evidence of his interest in the fund, expressed in "units of participation." The participation units were freely redeemable, as well as transferable to any other person who had executed a managing agency agreement with the bank. The fund was registered under the Investment Company Act of 1940, and the bank served as the fund's underwriter within the meaning of that Act. Additionally, the fund filed a registration statement pursuant to the Securities Act of 1933. The bank exercised full custody of and investment authority over the fund as investment adviser

pursuant to a management agreement. 401 U.S. at 622-23.

As authority for its creation and operation of the fund, Citibank relied upon an approval that it had obtained from the Comptroller of the Currency pursuant to a regulation promulgated by the Comptroller in 1962 under 12 U.S.C. § 92a. The Court held that regulation invalid. It recognized that national banks traditionally had enjoyed the power to commingle trust funds on the one hand and to act as managing agent on the other. However, the Court held that the union of those powers in the case of the bank-sponsored fund simultaneously violated the prohibitions of Sections 16 and 21 of the Glass-Steagall Act.

In reaching its conclusion, the Court emphasized the history of the ill-fated securities affiliates of commercial banks and the congressional objective reflected in Glass-Steagall to separate commercial banking from securities issuance and marketing. The Court noted that at the time of enactment of Glass-Steagall, the failure of the Bank of the United States in 1930 was attributed to the bank's activities in connection with its numerous securities affiliates. 401 U.S. at 629. Congress was "concerned that commercial banks . . . had both aggravated and been damaged by the stock market decline partly because of their direct and indirect involvement in the trading and ownership of speculative securities." *Id.* at 630. Thus, Congress' prophylactic goal was to prevent

> "hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments." 401 U.S. at 630.

The Court stressed that Glass-Steagall was a "prophylactic measure." 401 U.S. at 639. Congress had elected broadly to prohibit activities that had demonstrated potentials for abuse, rather than to attempt to outlaw only the "hazards" so as to enjoy the benefits supposedly attendant upon "competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business." *Id.* at 630. Congress sought to avoid the promotional pressures to which commercial banks inevitably would become subject once they went beyond "purchasing and selling . . . securities and stock without recourse, solely upon the order, and for the account of, customers" (Glass-Steagall Section 16) and engaged, even to a limited extent, in "issuing, underwriting, selling, or distributing" securities (Section 21).

Promotional incentives created the likelihood that banks would take measures to support their sponsored investment entities inconsistent with the interests of the banks' depositors. Thus, a commercial bank would be tempted, among other things, to "make its credit facilities more freely available to those companies in whose stock or securities the affiliate has invested or become otherwise involved," and to render less than "disinterested investment advice" to customers. 401 U.S. at 631-33. In general, the Court said,

> "Congress feared that the promotional needs of investment banking might lead commercial banks to lend their reputation for prudence and restraint to the enterprise of selling particular stocks and securities, and that this could not be done without that reputation being undercut by the risks necessarily incident to the investment banking business." 401 U.S. at 632.

The Court concluded that the "same hazards are clearly present when a bank undertakes to operate an investment fund." 401 U.S. at 636. It noted that a "bank that operates an investment fund has a particular investment to sell." *Id.* Unless the bank could generate public interest in fund participations as compared to other investments, the size of the fund, and the bank's fee, would suffer. Promotional pressures would be generated by competition with nonbank investment funds. Thus, the "bank would have a salesman's stake in the performance of the fund, for if the fund were less successful than the competition the bank would lose business and the resulting fees." *Id.* at 636-37. Significantly,

> "A bank that operated an investment fund would necessarily put its reputation and facilities squarely behind that fund and the investment opportunity that the fund offered. The investments of the fund might be conservative or speculative, but in any event the success or failure of the fund would be a matter of public record. Imprudent or unsuccessful management of the bank's investment fund could bring about a perhaps unjustified loss of public confidence in the bank itself." *Id.* at 637.

In addition, the Court observed that the other hazards against which Glass-Steagall was directed are present where a bank creates and operates an investment fund—for example, the risks that the bank might make unsound loans or lend other assistance to the fund or the companies in which the fund invested, or exploit its confidential relationships with its commercial and industrial creditors for the benefit of the fund, or pursue other avenues to support the fund inconsistent with the interests of its depositors. *See* 401 U.S. at 637-38.

In sum, the Court concluded that the bank-sponsored investment activity before it "involve[d the] bank in the underwriting, issuing, selling, and distributing of securities in violation of §§ 16 and 21 of the Glass-Steagall Act." 401 U.S. at 639. At no point did the Court suggest that its reasoning as outlined above was narrowly confined to open-end funds, nor is there any basis to suggest that the Court's reading of Glass-Steagall should be so limited.

C. The Distinction Sought To Be Drawn Between Open-End and Closed-End Investment Companies Is Untenable

In its Regulation and accompanying Interpretive Ruling, the Board has purported to recognize the controlling authority of this Court's *Camp* decision. At the same time, however, the Board seeks to cut back on the reach of *Camp* by seizing upon the happenstance that the investment fund there under consideration was of an open-end variety. The Board has hit upon a non-distinguishing feature of the case. The Court's decision in *Camp* did not turn upon the difference between open- and closed-end funds. To the contrary, the Court there spoke of the hazards of bank creation and operation of "investment funds" generally—a term that plainly encompasses closed- as well as open-end funds. *See, e.g.*, 401 U.S. at 634-38.

The language of Glass-Steagall, its relevant history, and the policies underlying its enactment as identified in *Camp* do not allow any such differentiation as that which the Board has sought to create here.

1. *Glass-Steagall Sections 16 and 21 Independently Bar Banks from Sponsoring Closed-End Investment Companies*

On their face, Glass-Steagall Sections 16 and 21 prohibit the association of a bank with the initial issuance, underwriting, sale, and distribution of the securities of *any* investment fund sponsored by the bank, as well as the subsequent portfolio transactions for any such fund, whether open- or closed-end.

Section 16, as supplemented by Section 5(c), Fifth, provides pertinently:

> "The business of dealing in investment securities by [any national or state member bank in the Federal Reserve System] shall be limited to purchasing and selling such securities without recourse, *solely upon the order, and for the account of, customers, and in no case for its own account, and the* [*member bank*] *shall not underwrite any issue of securities* . . . ." 48 Stat. 184 (emphasis supplied).[4]

By its terms, the Section prohibits member banks from underwriting securities. Further, banks may purchase and sell securities "solely upon the order, and for the account of, customers." Thus, bank sponsorship of *any* investment company (whether closed- or open-end) that issues securities for distribution and sale to the general public is squarely prohibited.

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[4] Under Section 16, as enacted in 1933, "investment securities" were narrowly limited to debt instruments. Thus, the Section granted no authority to banks to purchase stock even for the account of customers, and it prohibited any purchase of stock by banks for their own account. The 1935 amendments to the National Banking Act clarified that a national bank could buy stock for the account of customers, but not for its own account. 49 Stat. 709; *cf.* S. Rep. No. 1007, 74th Cong., 1st Sess. 17 (1935); H.R. Rep. No. 742, 74th Cong., 1st Sess. 18 (1935); *cf. Camp, supra,* at 623-24 n.10.

The legislative history establishes that Section 16 was intended to permit banks to purchase and sell investment securities only at the request, and for the account and convenience, of existing customers. S. Rep. No. 77, 73d Cong., 1st Sess. 16 (1933). That view was confirmed by the Comptroller of the Currency in 1936 in the following description of the effect of the Section:

> "In general this clause confines the activity of a national bank in purchasing and selling securities for the accounts of customers to that of an accommodation agent, *the purpose being to prevent such banks from engaging in the business of dealing in securities for profit,* without limiting the service which may be rendered to customers in purchasing and selling securities upon their orders and for their accounts . . . ." Bulletin, Comptroller of the Currency ¶ 35 (Oct. 26, 1936) (emphasis supplied).

There is no suggestion, either in the legislative history or in any subsequent interpretation of Section 16, that the provision somehow contains an exception authorizing member banks to purchase and sell securities for profit on any basis other than "solely upon the order, and for the account of, customers." That history intimates no exception for investment companies at all, let alone for closed-end funds.

Contrary to the Board's suggestion in its March 8, 1974 ruling (Pet. App. 53a), a bank cannot avoid the restrictions of Section 16 by the simple device of creating and managing its own "customers." In *Camp,* this Court rejected the argument that banks should be permitted to engage in securities transactions on behalf of sponsored investment companies on the theory that such activities somehow were akin to activities for the accounts of *bona fide* customers. *See* 401 U.S. at 634-38.

Section 21 of Glass-Steagall provides pertinently:

> "[I]t shall be unlawful . . . [f]or *any* person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, *selling, or distributing* . . . stocks, bonds, debentures, notes, or other securities, to engage at the same time *to any extent whatever* in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor . . . ." 48 Stat. 189 (emphasis supplied).

By its terms, this Section prohibits *any* enterprise from engaging simultaneously in two specified lines of commerce—(i) "issuing, underwriting, selling, or distributing . . . securities"; and (ii) commercial banking, *i.e.*, "receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor." Section 21 thus forces every enterprise, no matter how denominated, to a choice. It may engage either in commercial banking; or it may engage in the business of issuing, underwriting, selling, or distributing securities. It may not do both.

The prohibition of Section 21 is unqualified. It makes no exception for the sponsorship of closed-end investment companies. It is not limited to persons who, in the Board's language, are "primarily or frequently" engaged in the business of issuing, underwriting, or distributing securities at the same time that they are engaged in commercial banking. Bank sponsorship of closed-end funds thus cannot be excused under Section 21 on the ground that such funds "are not primarily or frequently engaged in the issuance, sale and distribu-

tion of securities." Any bank so involved necessarily would be "engaged" to some extent in the critical initial "issuing, underwriting, selling, or distributing" of the fund's securities, in contravention of the mandate of the Section that commercial and investment banking be divorced.

2. *The Background of the Glass-Steagall Legislation Shows That Congress Could Not Have Intended To Exclude Closed-End Investment Companies From the Statutory Prohibitions*

The Board's reading of Glass-Steagall to permit bank sponsorship of closed-end funds ignores specific and voluminous contemporaneous evidence to the contrary. As an historical matter, it was public speculation in closed-end, not open-end, investment companies that was before the Congress at the time of enactment of Glass-Steagall. In 1929, open-end investment companies accounted for only five percent of the total assets of all management investment companies. Not one open-end investment company had been sponsored by a commercial bank or bank affiliate. *See* SEC Report on Investment Trusts and Investment Companies (hereafter "SEC Report") (Part 2), H.R. Doc. No. 70, 76th Cong., 1st Sess. 124 (Table 25) (1939). *Every* investment company sponsored by a commercial bank or its securities affiliate, including those whose abuses filled the pages of a contemporaneous SEC study, was of the closed-end variety. *Id.* at 115-24.

Closed-end investment companies were intimately associated with the investment bankers that had sponsored the vast bulk of such funds. *Id.* at 124 (Table 25). As this Court noted in *Camp,* Congress generally intended to divorce commercial banking from the kinds of activities in which investment bankers were engaged.

401 U.S. at 635. On this score alone, there is ample basis to conclude that Congress contemplated that Glass-Steagall would prohibit banks from sponsoring closed-end funds.

There is a certain irony in the Board's suggestion that in prohibiting banks from engaging in securities distributions to any extent—not merely "principally" or even "primarily"—Congress in Section 21 intended to excuse bank involvement in the initial issuance and sale of closed-end fund securities, on the theory that such sales possibly might not be followed by subsequent distributions as in the case of open-end funds. The historical explanation for the different distribution patterns of closed- and open-end funds lay in the different character of their sponsors. Closed-end funds exploited the prestige of their sponsors to achieve rapid distribution through public offerings of securities. Open-end funds relied on the constant selling efforts of their less well-known sponsors over time to achieve distribution. *See* SEC Report, *supra* (Part 3), at 804. Thus,

> "[a]n investment trust or investment company which could obtain the backing of some established institution at once possessed the elements of respectability and experience which the association implied. These connections were of immeasurable value in marketing the shares of investment trusts and investment companies and often the sponsors sought to exploit these affiliations.
>
> "*The reputation which commercial banks,* investment bankers, and brokers *enjoyed* in those years during which the *closed-end* management investment trusts and investment companies received their greatest impetus *was probably utilized and exploited as an aid to distribution as much as*

any other sponsorship." *Id.* at 892 (emphasis supplied).

The contemporaneous materials were replete with accounts of closed-end fund organizers who had sought out association with banking institutions to promote the marketing of the shares of their companies. *E.g., id.* at 892, 907. Based on the prestige of their sponsors, closed-end funds achieved massive public distribution of their securities in the years preceding the enactment of Glass-Steagall, to the point that they far eclipsed open-end funds in importance. As noted above, in 1929 closed-end funds accounted for 95 percent of all the assets of management investment companies in the country. It is far-fetched to suggest that Congress somehow intended to prohibit bank involvement in the trickling securities distribution of open-end funds, while leaving open such involvement in the flash-flood distribution of closed-end funds.

3. *The Functional Similarities of Closed- and Open-End Funds Preclude the Distinction Now Urged by the Board*

Throughout its Brief to this Court, the Board relies upon a single difference between open- and closed-end investment companies—that in the distribution of their shares, open-end companies typically engage in a continuous process of redemption and issue, whereas closed-end companies typically do not continuously issue and sell their own securities. On that basis, the Board urges that the two types of funds may be accorded disparate treatment under the Glass-Steagall Act.

The Board has overstated the difference between open- and closed-end funds, and has failed to show

that the difference is significant in terms of the policies that underlie Glass-Steagall. That is the case even though the Board variously implies that closed-end funds are different *only when* they distribute their shares infrequently (*e.g.*, Pet. Br. 11, 27, 30, 45 n.38) and that they are different because as a *matter of definition* they make such distributions only infrequently (*e.g., id.* at 11, 24-27, 29, 34-35).

First, the ongoing relationship of banks to their sponsored funds does not depend materially on whether the funds are open- or closed-end. In both cases, banks have been intimately involved at the first stages of organization of the funds and during the initial distribution of fund securities. In both cases, the funds' key officers and employees have been officers and employees of the banks. In both cases, the banks have had full sway in the investment operations of the funds, and have assumed other administrative functions and expenses. In both cases, the banks have had a salesman's stake in the performance of the funds, in that their fees typically are defined as a percentage of the funds' net asset values.

Second, closed-end companies may, and do, issue and sell their securities to the public from time to time after the initial distribution of their securities is completed. *See* Appendix A. Under Section 23(b) of the Investment Company Act, 15 U.S.C. § 80a-23(b), a closed-end investment company may sell its stock as long as the price is at the current net asset value of the stock. Moreover, closed-end companies frequently adopt some form of dividend reinvestment plan, whereby the shareholder's periodic dividend is used to pur-

chase additional shares of the fund's stock for the shareholder's account. *See* R. 317.

Third, closed-end funds can, and do, convert into open-end funds. Advance Investors Corporation, one of the closed-end funds sponsored by Citibank, N.A., converted to an open-end fund after commencing existence in the closed-end configuration to take advantage of the Regulation (R. 2915-3102). In allowing banking institutions to sponsor closed-end funds without prohibiting conversion, the Board has created an obvious loophole by which banking institutions may evade the prohibition expressed in *Camp* through the creation of a closed-end fund that can be open-ended at the first convenient opportunity. Also, the Board unnecessarily has placed itself in the position of having to attempt to determine the original intentions of sponsors of closed-end funds when conversions occur. It is not apparent that the Board has rushed to embrace this ongoing policing function in the industry. To the contrary, the Board refused to explore such problems through a public hearing when pressed by the Institute below (R. 172-73) and, so far as we are aware, has undertaken no enforcement action since then.

Fourth, a holding company or its subsidiary is free under the Board's Regulation to sponsor a multiple series of closed-end funds, resulting in the more or less continuous issuance of investment securities to the public. The Board has not explained why such bank sponsorship of a series of closed-end funds should be permitted when the sponsorship of a single open-end fund is not.

Finally, it is true that in the cases of bank-sponsored closed-end funds detailed in the evidence before the

Board, the underwriting and distribution functions formally were placed in the hands of third parties to preserve the appearance of noninvolvement by the banks in those areas. But the banks were involved in all the critical initial contractual arrangements for the launching of the funds. *Camp* proscribes indirect as well as direct engagement of banks in the sale of securities. The grounds for the proscription of indirect involvement are found both in Glass-Steagall Section 16's strict limitations on bank dealings in securities and Section 21's prohibition on a bank's engaging to any extent—not merely "principally" or "primarily"—in the issuance, underwriting, sale, or distribution of securities.

In sum, the language, history, and policies of Glass-Steagall Sections 16 and 21 compel the conclusion that the sponsorship of closed-end investment companies is just as forbidden to banks as is their sponsorship of open-end counterparts. Insofar as the Board's Regulation and Interpretive Ruling purport to authorize such sponsorship, they are unlawful.[5]

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[5] The Board (Pet. Br. 35 n.28) and its supporting *amici* (Am. Br. 21 n.26) suggest that during the course of the administrative proceedings, counsel for the Institute conceded the materiality of the difference between open- and closed-end investment companies. The suggestion is conveyed through the time-honored device of omitting the pertinent aspects of the quotation relied upon. Before the Board, counsel stressed:

> "[T]he Supreme Court pointed out a number of other conflicts which it considered inimical to the best interests of banking that could inhere. An identification of the investment company with the bank, and perhaps a poor performance on the part of the investment company somehow or other operating to lessen public confidence in the bank, that same conflict and that same evil would be present whether the investment company were closed-end or open-end" (R. 195-96).

II. SECTION 4(c)(8) OF THE BANK HOLDING COMPANY ACT DOES NOT EMPOWER THE BOARD TO AUTHORIZE BANK HOLDING COMPANIES AND THEIR SUBSIDIARIES TO SPONSOR CLOSED-END INVESTMENT COMPANIES

The Board's determination that the sponsorship of closed-end investment companies is "so closely related to banking . . . as to be a proper incident thereto" cannot be sustained. The history of the bank holding company legislation and past rulings of the Board itself, both under Section 4(c)(8) and under other statutory schemes, demonstrate that sponsorship of such investment media for promotion of stock sales to the general public is not a "proper incident" to the banking function and therefore cannot be undertaken by bank holding companies.

A. The Bank Holding Company Act Narrowly Restricts the Nonbanking Activities of Bank Holding Companies to "Proper Incidents" of Banking

1. *The History of the Bank Holding Company Legislation Demonstrates That Congress Intended No Departure from the Pertinent Prohibitions of the Glass-Steagall Act*

The dual objectives of the Bank Holding Company Act of 1956 were to regulate the growth of bank holding companies and to restrict severely the types of activities in which such companies could engage. *See Lewis* v. *BT Investment Managers, Inc.*, 48 U.S.L.W. 4638, 4643 (No. 79-45) (June 9, 1980); S. Rep. No. 1095, 84th Cong., 1st Sess. 2 (1955); *cf. Board of Governors* v. *First Lincolnwood Corp.*, 439 U.S. 234, 244 (1978). Said the Senate Committee on Banking and Currency in reporting out the measure:

> "In the opinion of your committee, public welfare requires the enactment of legislation providing

> Federal regulation of the growth of bank holding companies and the type of assets it is appropriate for such companies to control. In general, the philosophy of this bill is that bank holding companies ought to confine their activities to the management and control of banks and that such activities should be conducted in a manner consistent with the public interest. *Your committee believes that bank holding companies ought not to manage or control nonbanking assets having no close relationship to banking.*" S. Rep. No. 1095, 84th Cong., 1st Sess. 1 (1955) (emphasis supplied). *Accord,* H.R. Rep. No. 609, 84th Cong., 1st Sess. 16 (1955).

In their hearings, both houses of Congress had documented abuses that had arisen from the combination of banking and nonbanking enterprises in the same economic unit. *Id.* at 4-5. William McChesney Martin, Jr., Chairman of the Board of Governors, presented his views on the dangers involved generally when bank holding companies enter areas not allowed to banks:

> "[T]here is nothing in existing law which prevents the combination under the same control, through the holding company device, of both banking and nonbanking enterprises. Obviously, this makes it possible for the credit facilities of a controlled bank to be used for the benefit of the nonbanking enterprises controlled by the holding company. Moreover, the ordinary non-banking business requires a managerial attitude and involves business risks of a kind entirely different from those involved in the banking business. Banks operate largely on their depositors' funds. These funds should be used by banks to finance business enterprises within the limitation imposed by the banking laws and should not be used directly or indirectly for the purpose of engaging in other businesses which are not subject to the safeguards imposed by the banking laws." ***Hearings on H.R.***

2674 Before the House Comm. on Banking and Currency, 84th Cong., 1st Sess. 14 (1955).

Thus, Congress determined to subject bank holding companies to the same regulation as the banking institutions that they controlled. Congress recognized that it was just as important for bank holding companies to limit their activities to sound practices as it was for banks to do so. *See* H.R. Rep. No. 609, *supra* at 7, 11.

Section 4(a) of the Bank Holding Company Act, 12 U.S.C. § 1843(a), prohibited bank holding companies owning or controlling two or more banks to acquire or retain interests in any nonbanking enterprises. *See Lewis* v. *BT Investment Managers, Inc.,* 48 U.S.L.W. at 4642. However, Section 4(c)(6) of the Act provided a limited exemption. Under that Section, bank holding companies were permitted to hold

> "shares of any company *all the activities of which are of a financial, fiduciary, or insurance nature and which the Board . . . has determined to be so closely related to the business of banking* or of managing or controlling banks *as to be a proper incident thereto* and as to make it unnecessary for the prohibitions of this section to apply in order to carry out the purposes of this Act." 70 Stat. 137 (emphasis supplied).

The court of appeals below carefully reviewed the history of the 1956 legislation. It properly concluded that the Board's authority to act under the exemptive provision of Section 4(c)(6) "was to be a narrow one." 606 F.2d at 1017 (Pet. App. 31a).

In the years following enactment of Section 4(c)(6), the Board's exercise of its powers under the Section was consistent with the understanding reflected in the

court's opinion below. The Board interpreted the language of Section 4(c)(6) to require a "direct and significant connection" between the proposed activities of the company to be acquired by the bank holding company and the business of banking as conducted by the particular bank holding company or bank subsidiary involved. *See Hearings on H.R. 6778 Before the House Comm. on Banking and Currency,* 91st Cong., 1st Sess., Part 1, at 199 (1969) (statement of Chairman Martin); *cf. Application of TransAmerica Corp.,* 43 Fed. Res. Bull. 1014 (1957).

Significantly, there is no indication that the banking industry ever regarded the 1956 legislation as having removed the prohibitions against entry into securities marketing originally stated in the Glass-Steagall Act. That understanding also is reflected in the subsequent legislative recognition that the 1956 Act was intended to apply "the general purposes of the Glass-Steagall Act of 1933—to prevent unduly extensive connections between banking and other businesses." S. Rep. No. 1179, 89th Cong., 2d Sess. 2 (1966).

In 1966, Congress amended the Bank Holding Company Act, without effecting any pertinent change in the law. Section 4(c)(6) was renumbered Section 4(c)(8), without substantive change. 80 Stat. 239. Other changes, also of a technical nature, related to the provisions of Glass-Steagall concerning bank affiliates and holding companies. These changes will be considered in Part III of this Brief.

In 1970, Congress again amended the Bank Holding Company Act. The court of appeals below, which comprehensively reviewed the 1970 amendments, correctly identified their main objective as the extension of the

requirements and prohibitions of the 1956 Act to one-bank holding companies. 606 F.2d at 1018 (Pet. App. 32a-33a). Prior to 1956, such holding companies had formed a relatively insignificant part of the American banking industry, being limited primarily to companies controlling small banks. However, following the adoption of the Bank Holding Company Act, the number of one-bank holding companies increased dramatically, reaching a peak in the late 1960s.[6] Equally important, the device became popular with the nation's largest banks as a means of engaging in nonbanking enterprises free from federal regulatory control. *See Staff of House Comm. on Banking and Currency,* 91st Cong., 1st Sess., *The Growth of Unregistered Bank Holding Companies—Problems and Prospects* 6-7 (Comm. Print 1969); 115 Cong. Rec. 32898-900 (1969) (remarks of Representatives Widnall and Del Clauson); *Board of Governors* v. *First Lincolnwood Corp., supra,* at 247. As J. L. Robertson, Vice Chairman of the Board of Governors, told the House Committee on Banking and Currency:

> "when Congress has clearly limited the powers of banks, they should not be permitted to circumvent such limitations either through subsidiary corporations or through affiliation in a holding company system. If the limitation is to be removed or modified, it should be by congressional action. Before Congress does act to alter a limitation, it should decide whether the proposed activity is appropriate for banks to engage in directly. If so, the law should be changed in order that they may do so

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[6] For a discussion of the increased use of the one-bank holding company device, *see American Banker,* Feb. 5, 1969, at 16, col. 1; Shapiro, *The One-Bank Holding Company Movement: An Overview,* Banking L. J. 291 (1969).

> themselves, as well as through a subsidiary or through an affiliate in a holding company." Hearings on H.R. 6778, *supra* at 207 (1969).

As part of the 1970 amendments, Congress revised Section 4(c)(8) to exempt from the prohibition against nonbanking activities the holding company's possession of

> "shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be *so closely related to banking or managing or controlling banks as to be a proper incident thereto.*" 84 Stat. 1765 (emphasis supplied).[7]

The Section, as revised, retained the central formulation of the provision as originally enacted—that the exempted activity be "so closely related to banking . . . as to be a proper incident thereto . . . ." However, the proposed revision went through numerous stages before its reversion to the original language. Before the Congress, the Board had favored legislation that would have substituted the phrase "functionally related" for the "closely related" language of Section 4(c)(8), but that explicitly would have barred bank holding company sponsorship of investment companies in language essentially identical to Glass-Steagall Sec-

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[7] The replacement of the phrase "business of banking" with the word "banking" was intended to permit the Board to authorize activity closely related and properly incident to banking generally, rather than to the particular bank whose holding company happened to invoke the statute. 606 F.2d at 1020 (Pet. App. 38a); *cf.* Pet. Br. 47 n.42. The court below correctly described this change as expanding the geographic markets, but not the lines of commerce, of services deemed to meet the statutory criteria. 606 F.2d at 1020 (Pet. App. 38a). Similarly, the deletion of the phrase "of a financial, fiduciary or insurance nature" was intended to eliminate a redundancy (*see* Pet. Br. 48 n.42).

tion 20. *Hearings on H.R. 6778 Before the House Comm. on Banking and Currency,* 91st Cong., 1st Sess., Parts 1 & 2, at 90, 175, 418, 549 (1969); *Hearings on S. 1052, S. 1211, S. 1664, S. 3823, and H.R. 6778 Before the Senate Comm. on Banking and Currency,* 91st Cong., 2d Sess., Part 1, 18 (1970). In appearing before the Senate Committee, the Administration spokesman made clear that the government welcomed an explicit exclusion of bank holding companies from the "securities business," which exclusion he described as "traditional for years . . . ." *Id.*

In their reported bills, both the Senate and House committees included the "functionally related" language, although their reasons for the change differed, the Senate apparently intending to give the Board greater flexibility. S. Rep. No. 91-1084, 91st Cong., 2d Sess. 12 (1970). The House Committee adopted the "functionally related" language but would have prohibited holding company acquisition or retention of shares of any company "[e]ngaging in the underwriting, public sale, or distribution of mutual funds." H.R. Rep. No. 91-387, 91st Cong., 1st Sess. 9 (1969). That provision was not strong enough for the full House, which amended it on the floor to cover

> "[e]ngaging in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds or other similar securities, or of interests in any such securities, *whether or not any such interests are redeemable* and whether or not the securities to which any such interests relate are in a fund or account or are subject to discretionary sale or purchase . . . ." 115 Cong. Rec. 33133, 33139 (1969) (emphasis supplied).

The underscored language, which could be seen as a response to the newly emerging "functionally related" test, plainly would have subjected closed- as well as open-end funds to the general prohibition of Section 4(a).

The final language of Section 4(c)(8) was determined in conference. The result was the deletion of the specific prohibition against securities activities contained in the House version, but a return to the "closely related . . . proper incident" language of the 1956 Act.

Significantly, a colloquy on the Senate floor upon the adoption of the Conference Committee Report confirms the congressional understanding that the amended Section 4(c)(8) would not affect the Glass-Steagall proscriptions:

> "MR. WILLIAMS of New Jersey. I have one question I should like to ask the chairman of the committee.
>
> "Both the Senate and House bills contained, in Section 4(c)(8), substantially similar language reiterating the existing law embodied in the Glass-Steagall Act which provides, essentially, for separation of commercial banking and the securities business. This language does not appear in the bill agreed to by the conferees. *I wonder whether there was any intention to imply that the very securities-related activities forbidden to banks directly may nevertheless be engaged in by bank-holding companies or their nonbanking affiliates.*
>
> "MR. SPARKMAN. *The answer to the Senator's question is that there clearly was not. As it now stands, the Glass-Steagall Act broadly prohibits both banks and their affiliates from engaging in what we commonly understand to be the securities business.* There are some specific exceptions, of

course, but I can assure you that we did not mean to enlarge or contract them here. We regarded that general prohibition as being so clearly applicable to the subjects of this bill as to make a restatement of it unnecessary. The provision to which you referred is already complicated enough. In short, *we did not intend to amend or modify, directly or indirectly, any limitations on the activities of banks, bank-holding companies or any of their affiliates, now contained in the Glass-Steagall Act. If Congress is to change that longstanding, fundamental statement of public policy, we will have to do so in other legislation.* I hope there is no longer any misconception on that point.

"MR. WILLIAMS of New Jersey. It is reassuring, indeed, to know that the Glass-Steagall Act has not been disturbed in any way and that there is no intention at all here to do so." 116 Cong. Rec. 42430 (1970) (emphasis supplied).

In sum, the Bank Holding Company Act of 1956 and its 1966 and 1970 amendments left intact the pertinent prohibitions of Glass-Steagall. The Glass-Steagall policy of divorcing commercial banks from the issuance and marketing of securities was reaffirmed.

2. *The Board Cannot Show That Activity Affirmatively Prohibited to Banks Under Glass-Steagall Sections 16 and 21 Nonetheless Is a "Proper Incident" of Banking Under Section 4(c)(8)*

Before this Court, the Board intimates that under Section 4(c)(8), as amended in 1970, it somehow acquired a broad administrative discretion to authorize a wide range of activities that the Board believes meet the "closely related" standard (*e.g.*, Pet. Br. 47). The Board's argument overlooks that under Section 4(c)(8), even following the 1970 amendment, the statutory test is not simply one of "relatedness." Rather, the

question posed by the statute in each case is whether the proposed activity is "*so* closely related to banking . . . as to be a *proper* incident thereto" (emphasis supplied).

Both the language of the statute and the history of the 1970 amendments demonstrate that two distinct standards—a "close relation" and a "proper incident" —must be met. H.R. Rep. No. 91-1747, 91st Cong., 2d Sess. 21-22 (1970). *Accord, NCNB Corp.* v. *Board of Governors,* 599 F.2d 609, 610-11 (4th Cir. 1979); *Association of Bank Travel Bureaus, Inc.* v. *Board of Governors,* 568 F.2d 549, 551-52 (7th Cir. 1978); *National Courier Association* v. *Board of Governors,* 516 F.2d 1229, 1232 n.2 (D.C. Cir. 1975); *Independent Bankers Association of Georgia* v. *Board of Governors,* 516 F.2d 1206, 1215 (D.C. Cir. 1975); *BankAmerica Corp.* v. *Board of Governors,* 491 F.2d 985, 988 (9th Cir. 1974). The Board itself has acknowledged that a two-part test is involved. *Association of Bank Travel Bureaus, Inc.* v. *Board of Governors, supra,* 568 F.2d at 551-52.

The legality of the proposed activity necessarily is considered a part of the "proper incident" test under Section 4(c)(8), for statutes proscribing a given activity reflect public policy as determined by the legislature. *See, e.g., Alabama Association of Insurance Agents* v. *Board of Governors,* 533 F.2d 224, 252-53 (5th Cir. 1976), *vacated in part,* 558 F.2d 729 (1977), *cert. denied,* 435 U.S. 904 (1978); *Independent Bankers Association of Georgia, supra,* 516 F.2d at 1222-24. The Board has recognized the impropriety of permitting bank holding companies to engage in activities that are forbidden by law to banks. *Montana Shares, Inc.,* 47 Fed. Res. Bull. 767, 772 (1961).

As we have demonstrated above in Part I of this Brief, the Glass-Steagall Act prohibits banks from

sponsoring investment companies, whether open- or closed-end. This is not simply a situation in which the activity happens to be *ultra vires* the banks' statutory authority. As a matter of positive law, Glass-Steagall affirmatively prohibits such activity on the part of banks. It follows that the Board cannot find such activity to be "a proper incident" of banking under Section 4(c)(8) for bank holding companes. Were it otherwise, a bank such as Citibank, which failed in *Camp* in its effort to sponsor its own securities investment vehicle, could accomplish the forbidden result by creating a parent one-bank holding company and causing that parent to sponsor a closed-end fund.

The Board contends that its interpretation of Section 4(c)(8) somehow draws support from the immediately preceding Section 4(c)(7), 12 U.S.C. § 1843 (c)(7). *See* Pet. Br. 42-43. Again, the Board errs. Section 4(c)(7) originated in 1956 as Section 4(c)(5). That section exempted from the investment requirements of the Act

> "the *ownership* by a bank holding company of shares, securities, or obligations of an investment company which is not a bank holding company and which is not engaged in any business other than investing in securities, which securities do not include more than 5 percentum of the outstanding voting securities of any company and do not include any single asset having a value greater than 5 percentum of the value of the total assets of the bank holding company." 70 Stat. 136 (emphasis supplied).

The legislative history of this Section makes clear that the provision was drafted to allow a specific bank holding company in Kentucky to retain its pre-existing ownership of its interest in a subsidiary investment

company. 102 Cong. Rec. 6128 *et seq.* (1956). A similar provision had appeared in some of the bills introduced in Congress prior to 1956, but it was not in the Senate bill that was reported out of committee. *Id.* The provision was added on the Senate floor. There was general recognition that in its absence, the Kentucky bank holding company in question would be unable to retain its investment in the investment company securities. *Id.*

As written, Section 4(c)(7) permits bank holding companies to make the same investments indirectly, through the means of an investment company, that they could make directly under Section 4(c)(6), which authorizes a bank holding company to retain or acquire "shares of any company which do not include more than 5 per centum of the outstanding voting shares of such company." 12 U.S.C. § 1843(c)(6). If anything, Section 4(c)(7) reflects a congressional determination that bank holding company involvement with investment companies shall be limited to "ownership" of such companies' stock, under narrowly defined circumstances. Mere ownership of investment company stock is a far cry from sponsorship of a closed-end investment company the shares of which are issued, offered, sold, and distributed to the public. Surely, Congress in legislating the tightly circumscribed provision for continued stock *ownership* in Section 4(c)(7), did not simultaneously intend to leave open the possibility of wholesale investment company *sponsorship* in the immediately following Section 4(c)(8).

B. Regulatory Rulings of the Board Confirm That Bank Holding Company Sponsorship of Investment Companies Cannot Be Deemed a "Proper Incident" of Banking

In a final effort to sustain its Regulation and Interpretive Ruling, the Board urges (Pet. Br. 53-59) that

the sponsorship of closed-end investment companies is an activity "closely related" to the traditional fiduciary functions of commercial bank trust departments, and therefore may appropriately be exempted under Section 4(c)(8).

The Board's litigating position is at variance with its settled regulatory practice. The Board previously has not considered that the creation and sale of investment media to the public are an appropriate fiduciary function. To the contrary, throughout the period of its supervision of the trust powers of national banks from 1913 until 1962, the Board consistently warned against abuse of the authority to employ common trust funds, and strictly limited such funds to trusts created for "bona fide" or "strictly fiduciary purposes." 24 Fed. Res. Bull. 4-5, 10 (1938). The Board held that it was "improper" for a bank to use "the common trust fund as a medium attracting individuals primarily seeking investment management of their funds." 42 Fed. Res. Bull. 228 (1956); *see also* 41 Fed. Res. Bull. 142 (1955); 92 *Trusts and Estates* 319-20 (1953). In ruling that "a Common Trust Fund should be used merely to aid in the administration of trusts by a trust institution through the commingled investment of funds of various trusts," the Board said:

> "While the operation of a Common Trust Fund might thus enable a trust institution to accept small trusts which it otherwise would be unwilling to handle, it was contemplated that trust guise or form should not be used to enable a trust institution to operate a Common Trust Fund as an investment trust attracting money seeking investment alone *and to embark upon what would be in effect the sale of participations in a Common Trust Fund to the public as investments.*" 26 Fed. Res. Bull. 393 (1940) (emphasis supplied).

As late as 1960, the Board proposed an amendment to its Regulation in order to ensure a "bona fide fiduciary purpose" in the use of common trust funds. 25 Fed. Reg. 12479 (1960). The Regulation would have excluded *inter vivos* trusts entirely from participation in common trust funds. *Id.* The proposal lapsed when the Board's supervisory authority with respect to national banks was transferred in 1962 to the Comptroller of the Currency.

Interestingly, the American Bankers Association, which appears here as *amicus* in support of the Board, has warned that a bank may not

> "operate a common trust fund so as to compete with savings departments or investment trusts, merely to swell the volume of its trust assets through the attraction of money seeking investment alone." Trust Division, American Bankers Association, *Common Trust Funds* 16 (2d ed. 1948); *see also id.* at 17, 22-23.

In sum, because the sale of investment media to the public never has been regarded as a proper activity of banks, the Board's Regulation cannot satisfy the statutory test that the activity approved be "so closely related to banking . . . as to be a proper incident thereto" under Section 4(c)(8).

III. THE REGULATION AND INTERPRETIVE RULING ARE INVALID AS APPLIED TO BANK HOLDNG COMPANIES

In issuing its Regulation and Interpretive Ruling, the Board acknowledged that the Glass-Steagall Act's prohibitions apply to bank holding companies as well as to banks. Indeed, while attempting to carve out an exemption for *closed*-end investment companies from

the strictures of the Act, the Board expressly determined that the sponsorship, organization, or control of an open-end investment company is forbidden to bank holding companies under Glass-Steagall. 12 C.F.R. § 225.125(f) (Pet. App. 85a).

Even though the Board's recognition of the Glass-Steagall limitations plainly derived from this Court's *Camp* decision, which rested upon Sections 16 and 21, the Board now seeks to put those Sections to one side, on the theory that they apply only to banks (Pet. Br. 23 n.15). Instead, the Board now contends that the only extant provision of Glass-Steagall that deals with the sponsorship of a closed-end investment company by a bank holding company or its nonbank subsidiary is Section 20 (*id.* at 23), a provision not even at issue in *Camp*.

As we shall demonstrate in this section of the Brief, the Board's argument is unpersuasive. It ignores the plain language of the Act, Congress' concern with the relationship between commercial bank affiliates and investment companies, and this Court's teachings in *Camp*.

A. Bank Holding Company Sponsorship of Investment Companies Violates the Glass-Steagall Act

The Glass-Steagall Act set out to divorce commercial banking from the issuance and marketing of securities to the maximum extent that Congress believed was constitutionally permissible. The background of the Glass-Steagall legislation

> "conclusively demonstrates that it was the unalterable and emphatic intention of Congress to divorce commercial banks from the business of underwrit-

> ing and dealing in securities." *Baker, Watts & Co.* v. *Saxon,* 261 F. Supp. 247, 252 (D.D.C. 1966), *aff'd sub nom. Port of New York Auth'y* v. *Baker, Watts & Co.,* 392 F.2d 497 (D.C. Cir. 1968).

That divorce involved not only banks but their affiliates —bank subsidiaries, "sibling" corporations under common control with banks and corporate parents or holding company affiliates—all of which Senator Glass, sponsor of the legislation, referred to as "this Frankenstein in banking . . . ." 75 Cong. Rec. 9984 (May 11, 1932).

Under Glass-Steagall Section 16, national banks and state member banks were strictly limited in their purchases and sales of securities to acting for their customers' accounts and at their customers' orders. Under Section 20, national and state member banks were barred from affiliation with corporations engaged in the business of securities flotation and distribution. Under Sections 5(c), Seventh and 19, holding company affiliates of member banks were subjected to similar restraints by recourse to a requirement that they obtain a permit from the Board before voting the shares of the banks under their control. Under Section 21, all entities engaged in any respect in the commercial banking function, whether or not national banking associations, state member banks in the Federal Reserve System, or others, were banned from the securities marketing business. Finally, under Section 32, even if no formal corporate affiliation existed, personal interlocks between the securities marketing business and the commercial banking business were forbidden to a substantial degree.

There can be no doubt that Congress, in enacting Glass-Steagall, believed it had undertaken every pos-

sible remedial step within its constitutional power, as then understood, to divorce the banking industry from the issuance and marketing of securities to the general public.

As early as 1911, in a formal opinion to the Attorney General, the Solicitor General opined on the legality of a national bank's establishment of an "investment company," the shares of which were made available ratably to the shareholders of the bank, were tied to the bank's own securities, and further were pledged in trust to the operating trustees of the investment company. The Solicitor General condemned the arrangement as a violation of the national banking laws, which, he said, required that "the bank shall be conducted as a bank pure and simple *and not as a promoting agency of speculative investment companies.*" 75 Cong. Rec. 9899-9904 (1932) (emphasis supplied). Senator Glass made much of this opinion in his speech introducing the Glass legislation on the Senate floor, and references to the opinion figured prominently in the debates thereafter. *See, e.g.,* 75 Cong. Rec. 9887-89, 9898-904, 9909, 9911, 9975, 10069-70 (1932); 76 *id.* 1940, 1994 (1933); 77 *id.* 3725-26 (1933).

In 1920, the Comptroller of the Currency expressed concern about the proliferation of "securities companies" as affiliates of national banks:

> "*'Securities Companies' as Adjuncts to National Banks Often a Menace*
>
> "Some 'securities companies' operating in close connection with, and often officered by, the same men who manage the national banks with which they are allied, have become instruments of speculation and headquarters for promotions of all kinds of financial schemes. Many of the flotations promoted by the 'securities corporations' which

are operated as adjuncts to national banks have proven disastrous to their subscribers, and have in some instances reflected seriously not only upon the credit and the standing of the 'securities companies' by which they are sponsored, but also in some cases have damaged the credit and reputation of national banks with which the 'securities companies' are allied.

"It has been established clearly by decisions of the United States Supreme Court that a national bank can not, except as authorized by the Federal reserve act, hold the stock of other national banks or the stock of other corporations; *but these adjunct or auxiliary companies whose stockholders are identical with the stockholders of the national banks with which they are connected by various ties and devices frequently deal actively in stocks,* and they also sometimes acquire the ownership or control of other banks, National and State, through their stock purchases.

"In times of rising prices and active speculation some of these auxiliary corporations have made large profits through their ventures and syndicate operations, but their losses in other periods have been heavy, and they have become an element of increasing peril to the banks with which they are associated. *The business of legitimate banking is entirely separate and distinct from the kind of business conducted by many of the 'securities corporations,'* and it would be difficult, if not impossible, for the same set of officers to conduct safely, soundly, and successfully the conservative business of the national bank and at the same time direct and manage the speculative ventures and promotions of the ancillary institutions. These varying institutions demand a different kind of ability and experience on the part of those who manage them, and the two types of busi-

> ness when combined with one management are likely to be operated to the advantage of neither.
>
> * * *
>
> "*These ancillary companies are being used with increasing frequency for promotion of speculation and for dealing in bonds and stocks,* often those of new and unseasoned issues, and which are attended with improper hazard risk, *and as a means of enabling banks to do, indirectly through their instrumentality, things which they can neither safely nor lawfully do directly.*" 1920 Comptroller's Report, vol. 1, at 55-56.

This material too was brought before the Senate during its deliberations of the Glass bill. *See Hearings Pursuant to S. Res. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 71st Cong., 3d Sess., Appendix (Part VII), at 1067-68 (1931).

By March 1933, when President Roosevelt assumed office, the banking industry was in crisis. Thousands of banks, including many of the largest banks in the nation, had failed. *See* 75 Cong. Rec. 9892 (1932) (remarks of Sen. Glass). Depositors by the millions were confronted with the certain or likely loss of all or a substantial portion of their bank deposits. One of President Roosevelt's first actions was to declare an unprecedented "bank holiday." Presidential Proclamation No. 2038 (March 6, 1933); Presidential Proclamation No. 2039 (March 9, 1933); 1 A. Schlesinger, Jr., *The Age of Roosevelt* 474-81 (1957); 2 id. 4-8 (1959); and *see* authorities collected in Pet. Br. 32 n.25.

The Glass-Steagall legislation was adopted as the Banking Act of 1933 on June 16, 1933. It was one of the major pieces of reform legislation that moved to enactment through the Congress as part of the First

Hundred Days of the Roosevelt Administration. 2 A. Schlesinger, Jr., *supra* at 20-21. Whether viewed individually or in the aggregate, three statutory provisions of Glass-Steagall—Section 19, supplemented by Section 5(c), Seventh; Section 20; and Section 21—reflect a congressional determination to remove both banks *and* their affiliates from the type of involvement with investment companies that, in the view of Congress, had contributed to the debacle of the early 1930s.

1. *Sections 19 and 20 Removed Bank Affiliates and Holding Companies from the Business of Issuing and Marketing Securities*

Section 20 of Glass-Steagall was targeted at subsidiary and sibling corporations of national banking associations. This provision barred any member bank (whether a national banking association or a state member bank) from involvement with a subsidiary corporation or one under common control with the bank that in turn was involved in issuing and marketing securities. Specifically, Section 20 provided:

> "After one year from the date of the enactment of this Act, *no member bank shall be affiliated in any manner described in section 2 (b) hereof with any* corporation, association, business trust, or other similar *organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail* or through syndicate participation of stocks, bonds, debentures, notes, or other securities." 48 Stat. 188 (emphasis supplied).

The effect of the reference in Section 20 to the affiliations described in Section 2(b) was to confine the operation of Section 20 to affiliations between member banks on the one hand and their subsidiary and sibling

corporations on the other.[8] As Senator Walcott, one of the spokesmen for the legislation on the Senate floor, put it:

> "[W]hen we use the term 'affiliate' in this sense and in connection with this bill, we mean that divorced subsidiary of a bank, whether State or National makes no difference, whose business it is to underwrite, *purchase, and/or sell* various securities as they come along in the market from day to day and week to week." 75 Cong. Rec. 9905 (1932) (emphasis supplied).

The reason for Congress' enactment of Section 20 is clear. One of the primary abuses that motivated Congress to pass the Act was the widespread practice among commercial banks of engaging in the issuing and marketing of securities indirectly, through securi-

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[8] Section 2(b) of the Act adopted a definition of "affiliates" that reached both subsidiaries of banks and their sibling corporation, including

> "any corporation, business trust, association, or other similar organization—
>
> "(1) Of which a member bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 per centum of the number of shares voted for the election of its directors, trustees, or other persons exercising similar functions at the preceding election, or controls in any manner the election of a majority of its directors, trustees, or other persons exercising similar functions; or
>
> "(2) Of which control is held, directly or indirectly, through stock ownership or in any other manner, by the shareholders of a member bank who own or control either a majority of the shares of such bank or more than 50 per centum of the number of shares voted for the election of directors of such bank at the preceding election, or by trustees for the benefit of the shareholders of any such bank; or
>
> "(3) Of which a majority of its directors, trustees, or other persons exercising similar functions are directors of any one member bank." 48 Stat. 162-63.

ties or investment affiliates. The Senate Report accompanying the legislation said:

> "There seems to be no doubt anywhere that a large factor in the overdevelopment of security loans, and in the dangerous use of the resources of bank depositors for the purpose of making speculative profits and incurring the danger of hazardous losses, has been furnished by perversions of the national banking and State banking laws, and that, as a result, machinery has been created which tends toward danger in several directions.
>
> "*The greatest of such dangers is seen in the growth of 'bank affiliates' which devote themselves in many cases to perilous underwriting operations,* stock speculation, and maintaining a market for the banks' own stock often largely with the resources of the parent bank. This situation was never contemplated by the National Banking Act, and it would, therefore, appear that the affiliate system calls for the establishment of some legislative provisions designed to deal with the situation." S. Rep. No. 77, 73d Cong., 1st Sess. at 9-10 (emphasis supplied).

To like effect, the Senate Committee on Banking and Currency, writing of the activities of commercial banks during the period prior to 1933, noted:

> "Commercial banks not only played a vital part in securities transactions by the extension of credit to carry on these activities, but *directly engaged, in circumvention of the law, through the medium of their investment affiliates, in securities and other transactions prohibited to commercial banks.* This participation of commercial banks in the investment-banking field ultimately resulted in such gross abuses and malpractices, and occasioned such

losses to the banking institutions and the investing public, that the banking act of 1933 was passed divorcing commercial banking from investment-banking institutions." S. Rep. No. 1455, 73d Cong., 2d Sess. 156 (1934) (emphasis supplied).

Section 19 of Glass-Steagall controlled holding company affiliates. It imposed sweeping and stringent conditions upon such affiliates' exercise of the right to vote their stockholdings in the national banking associations. 48 Stat. 186. In a complementary provision, Section 5(c), Seventh imposed parallel conditions upon holding companies affiliated with state member banks. 48 Stat. 166. Holding company affiliates were defined in Section 2(c) of the Act to include any organization "[w]hich owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more than 50 per centum of the number of shares voted for the election of directors of any one bank at the preceding election, or controls in any manner the election of a majority of the directors of any one bank." 48 Stat. 163.

Section 19 was repealed in 1966, but that repeal was a technical revision only, without impact on the substantive law. As the Board correctly concedes (Pet. Br. 4 n.5, 17, 43, 47-50 & n.43, 52, 53), neither the Bank Holding Company Act of 1956 nor the amendments to that statute adopted in 1966 and 1970 cut back on the prohibitions contained in Glass-Steagall. *Accord, Board of Governors* v. *First Lincolnwood Corp.,* 329 U.S. at 246-47; S. Rep. No. 1179, 89th Cong., 2d Sess. 12 (1966). Thus, Section 19 properly may be considered at this point of the analysis.

In the provision directly pertinent here, Section 19, Fifth required a bank holding company applying for

permission to vote the shares of a subsidiary member bank to agree to remove itself from involvement in the operation of "securities companies" within five years of the filing of the application. In pertinent part, the paragraph provided:

> "Every such holding company affiliate shall, in its application for such voting permit, (1) show that it *does not own, control, or have any interest in, and is not participating in the management or direction of, any* corporation, business trust, association, or other similar *organization formed for the purpose of, or engaged principally in, the issue, flotation, underwriting, public sale, or distribution,* at wholesale or retail or through syndicate participation, *of stocks, bonds,* debentures, notes, *or other securities of any sort* (hereinafter referred to as 'securities company'); (2) agree that during the period that the permit remains in force it will not acquire any ownership, control, or interest in any such securities company or participate in the management or direction thereof; [and] (3) agree that if, at the time of filing the application for such permit, it owns, controls, or has an interest in, or is participating in the management or direction of, any such securities company, it will, within five years after the filing of such application divest itself of its ownership, control, and interest in such securities company and will cease participating in the management or direction thereof, and will not thereafter, during the period that the permit remains in force, acquire any further ownership, control, or interest in any such securities company or participate in the management or direction thereof . . . ." 48 Stat. 188 (amending R.S. § 5144(e)) (emphasis supplied).

It is apparent that the underscored portion of the paragraph essentially parallels the provision in Section 20, set forth above, that barred member bank

affiliations with securities-company subsidiary or sibling corporations.

In explaining its recourse to the permit procedure in Section 19, the Senate Report accompanying the legislation noted the evil presented by the phenomenon of "group banking" but explained the difficulties, believed to be of a constitutional nature, in dealing with the parent entities directly as in the case of member banks:

> "Closely allied in many points of similarity with the affiliate system is the plan of group banking in operation in some parts of the United States, working, in a few cases, on a large scale. In this system a holding company is organized under State law and proceeds to buy a majority of the stock of a series of banks, operating them thereafter through the holding company. In this way in some districts such holding companies control the reserve bank of the district through ownership of enough banks to carry an election. The difference between this plan and the affiliate system itself is that in the one banks are owned by a State-organized holding company, while in the other State-organized companies (affiliates) are owned by a national bank's stockholders, or in some cases directly by trust companies, under some form of law which amounts to ownership by the parent bank itself. *The evils of indirect control are similar in the two cases, and they may lead to similar abuses, as is seen when it is noted that holding companies also usually control companies organized for security financing.* However, such companies have in some parts of the United States become well rooted, and the difficulty of eliminating or abolishing them in any effective way is similar to the difficulty of eliminating or abolishing the affiliates of city banks. It is, therefore, thought best to attempt the control

and oversight of these companies on the following terms:

"(1) *Since the companies are State corporations, Congress has no control over them, except that which may be voluntarily granted.* However, since the staple of their ownership or holdings is the stock of National and State member banks, *it would seem that Congress may control the conditions under which such stocks may be owned and particularly voted.*

"(2) The affiliates of this type (holding companies) are prohibited from voting the stocks of national banks unless they are willing to undertake to accept examination by the Federal Reserve Board, *divest themselves of ownership of stock and bond financing concerns,* and comply with regulations designed to insure their ownership of sufficient free assets to make sure that they can satisfy the double liability of their shareholders in case any of the banks owned by such a company should go into the hands of receivers or be closed." S. Rep. No. 77, *supra,* at 10-11 (emphasis supplied).

There can be no doubt that Sections 19 and 20 together were intended to put bank affiliates—whether holding companies, subsidiaries, or siblings—out of the business of issuing and marketing securities. *See* 75 Cong. Rec. 9887, 9889 (remarks of Sen. Glass) (1932); 77 *id.* 3725, 3726 (same) (1933); 77 *id.* 3835 (remarks of Rep. Steagall) (1933). As the court below summarized the situation, Section 19's treatment of holding company affiliates "did not stem from any congressional perception that the securities activities of bank holding companies or their non-bank affiliates were any less insidious than those of banks themselves. . . . [I]t is clear that the hazards . . . of affiliation be-

tween banks and securities firms were present in the case of holding company affiliates also. . . . The different treatment for holding company affiliates stemmed solely from a congressional concern that, under the commerce clause as then restrictively interpreted, Congress did not have power to force a state-chartered bank holding company to divest itself of a state-chartered securities affiliate." 606 F.2d at 1015-16 (footnotes omitted) (Pet. App. 26a-28a); *see* especially *id.* at 1015-16 n.28 (Pet. App. 26a-27a).

In 1966, as noted above, Congress repealed Section 19. At the same time, it amended the definition of "affiliate" in Glass-Steagall Section 2(b) so as to combine it with the definition in Section 2(c) of "holding company affiliate," which was repealed. 80 Stat. 242. One effect of the amendment to Section 2(b) was to apply Glass-Steagall Section 20, the scope of which turned on the definition of "affiliate" in Section 2(b), to affiliations between member banks and their holding companies, as well as between member banks and their subsidiary and sibling corporations. Thus, Glass-Steagall's broad objective of regulating bank holding companies in Section 19 effectively was preserved in Section 20. *See* S. Rep. No. 1095, 84th Cong., 1st Sess. 12 (1955).

The scheme of bank holding company regulation as originally framed in Glass-Steagall Sections 2(b) and 19 renders irrelevant the contention, now advanced by the Board and its supporting *amici,* that it is the investment company, rather than the bank holding company itself, that technically is engaged in the "issue . . . public sale, [and] distribution" of securities (Pet. Br. 29; Am. Br. 17-21). Even as amended, Glass-Steagall still reaches sibling cor-

porations through Section 2(b) as amended and Section 20. On this basis, the Board properly concedes that a closed-end investment company managed by a bank holding company is a bank "affiliate" within the meaning of Glass-Steagall (Pet. Br. 11, 24 n.16). It hardly would accord with economic reality to deny that the sponsoring entity—the bank holding company—is itself fully involved in the "issue, . . . public sale, [and] distribution" of the securities of its investment company affiliate.

Rather, the Board seeks to avoid Section 20 (with its embodiment of holding company regulation from the old Section 19) on the ground that closed-end funds somehow are not "principally" engaged in the issuance of securities. This is the case, says the Board, because such funds "do not continuously issue and sell their own securities" (Pet. Br. 26). But as we have shown in Part I of this Brief, the Board's analysis fails to take into account that Glass-Steagall nowhere provides for such a distinction, and that its authors never contemplated the notion that the Act would reach only investment trusts of the open-end variety.

There is not one word in the Glass-Steagall legislative history that would support the Board's position that bank affiliate sponsorship of *open*-end investment companies was to be prohibited by Sections 19 and 20, while such sponsorship of *closed*-end companies was not. Certainly, the Board points to no such history. Instead, the Board invokes *Board of Governors* v. *Agnew*, 329 U.S. 441 (1947). There this Court construed the language of Glass-Steagall Section 32, which prohibits interlocking managements between national or state member banks on the one hand and, on the other, firms "engaged primarily in the business of purchas-

ing, selling, or negotiating securities . . . ." The Court noted approvingly the conclusion of the court below that Glass-Steagall had abolished as part of the bank affiliate system all underwriter affiliates that were either under the control of a member bank or were under common control with such a bank. 329 U.S. at 448. The Court further agreed with the Board that Glass-Steagall Section 32 should not be limited to circumstances in which the investment houses in question derived 51 percent or more of their income from the underwriting business. Rather, the Court held that Section 32 should be understood to refer to "essential" or "fundamental" business activities. The Court in *Agnew* was not called upon to consider whether the sponsorship of closed-end investment companies amounted to an activity prohibited by other provisions of Glass-Steagall, nor did the Court express an opinion on that question.

The Board (Pet. Br. 22-23) makes much of the discussion in *Agnew* of the varying degrees of involvement in the securities business with which Congress was concerned in Glass-Steagall—"those 'engaged' in underwriting, those 'primarily engaged' in underwriting, those 'engaged principally' in underwriting." 329 U.S. at 448. That passage is of no help to the Board here. Even on the assumption that Section 21 (to be discussed immediately below) contains a stricter prohibition than Section 20, barring any organization from both issuing securities and receiving deposits, so that the magnitude of the securities activities of the banking institutions within its reach is irrelevant, the prohibition found in Section 20, although less sweeping, still applies fully here. A closed-end investment company is not engaged in many different busi-

nesses. Its *raison d'etre* is to sell participations as an investment vehicle to the public. Such an entity necessarily is "principally engaged" in the issuance of securities.

It merits emphasis that the Board concedes that a bank holding company is prohibited by Section 20 from sponsoring an *open*-end investment company because an open-end investment company is "principally engaged" in the issuance of securities. The discussion of the functional similarities between closed- and open-end funds in Section I of this Brief demonstrates that the distinction drawn by the Board cannot be sustained. *See* pp. 29-32 *supra.* In addition, the initial sponsorship and distribution to the public of interests in the closed-end fund are all that is necessary to constitute a violation of Section 20. It is irrelevant that after such sponsorship and distribution have taken place, the closed-end fund may or may not issue securities thereafter. The "principal engagement" takes place at the time of the initial offering, when the distribution of the securities is the *only* activity of the entity.

2. *Section 21 Reinforced the Separation of Commercial Banking from Securities Issuing and Marketing*

Section 21 of Glass-Steagall, discussed in Part I of this Brief, provided a sweeping, all-inclusive ban on the admixture of the business of issuing and marketing securities and the business of banking. This Section imposed a death sentence, subject to a one-year grace period, upon *any* entity's engagement in commercial banking, when at the same time that entity was involved in the business of issuing and marketing securities. The provision was subject to enforcement by re-

course to criminal penalties prescribed in Section 21(b).

The prohibition contained in Section 21 was stated in the broadest possible terms. Unlike other Sections in Glass-Steagall, there was no qualification in Section 21 based upon the status of the regulated entities as federal or state, or member or nonmember banks.

The reach of Section 21 was confirmed by a technical amendment enacted in 1935. That amendment added the following proviso immediately after the original language:

> "*Provided,* That the provisions of this paragraph shall not prohibit *national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers* from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section 5136 of the Revised Statutes, as amended [by Glass-Steagall Section 16]." 49 Stat. 707 (emphasis supplied).

Thus, at the same time that it excepted from coverage the narrow range of securities activities permitted to national banks under Glass-Steagall Section 16, the 1935 proviso established that the prohibition of Section 21 extended to "national banks or State banks or trust companies (whether or not members of the Federal Reserve System) [and] other financial institutions or private bankers."

The Board now maintains that Section 21 somehow is inapplicable to bank holding companies (Pet. Br. 20). That is a reversal of the Board's view, implicitly embodied in its Interpretive Ruling, that this Court's decision in *Camp* (and therefore presumably Section

21) barred authorization to bank holding companies to sponsor open-end funds.

The limitation of Section 21 now proposed by the Board cannot be found in the statute. The Section prohibits "*any* person, firm, corporation, association, business trust, or other similar organization" (emphasis supplied) to engage simultaneously in commercial banking and the investment trust business. The provision is not limited to banks. So long as the entity that engages "to any extent whatever" in commercial banking also is engaged in the issuance, sale or distribution of securities to the public, the subject relationship is forbidden.

Surely the language employed by Congress in Section 21 is broad enough to deal with the evil feared. It strains credulity to suggest that the authors of Glass-Steagall would have been content to see their handiwork undone through the artifice of a layering of corporate entities that preserved a formal separation of commercial and investment banking while accomplishing their functional union.

The court below sustained the Board's contention that Section 21 does not apply to the activities of bank holding companies. Although agreeing "that the purposes of the Glass-Steagall Act are fully broad enough to encompass the activities of bank holding companies and their non-bank subsidiaries," the court held that the structure of the statute would not allow such an interpretation of Section 21. 606 F.2d at 1012 (Pet. App. 17a). The court viewed Sections 21 and 16 as dealing with converse situations. According to the court, Section 21 was designed to prohibit the investment banking houses from engaging in deposit bank-

ing, while Section 16 was designed to prohibit commercial banks from carrying on securities activities.

But Section 21 is far broader than Section 16, both in the nature of the activities prohibited and the variety of institutions covered. This Court recognized the distinction in *Camp,* when it found that the sponsorship of the mutual fund before it amounted not only to the bank's dealing in stock "for its own account," within the ban of Section 16, but additionally to an investment entity's "issuing" and "selling" stock or "other securities" while engaging in commercial banking, within the ban of Section 21. 401 U.S. at 625.

The court below also was influenced by the presence of Section 20, which dealt specifically with bank subsidiaries and siblings, and of Section 19, which dealt with bank holding company affiliates through the permit procedure. But the fact that Sections 19 and 20 collectively dealt with bank affiliates does not mean that those were the only Sections that could apply to such affiliates. By its terms, Section 21 was broader in its reach than Sections 19 and 20. In embracing the definitions of affiliates found in Sections 2(b) and (c), Sections 20 and 19 necessarily were limited in their reach to a certain extent, because they excluded from their coverage those affiliation relationships that did not happen to meet the percentage or control tests prescribed in Section 2. By contrast, Section 21 adopted no such percentage or control limitations. To that extent, it provided both a complementary and an expanded coverage.

Additionally, Section 19 was restricted in its scope by its disavowal of direct regulation of bank holding company affiliates as such, and its recourse to the less

direct route of regulating such affiliates' voting of their respective bank securities holdings. That approach left certain holding company affiliates free to continue to exercise functional control over their bank subsidiaries without formally voting their stock. That loophole was one of the considerations that influenced Congress to adopt the Bank Holding Company Act of 1956, discussed in this Brief in Part II. By contrast, Section 21 asserted a flat prohibition upon the commingling of commercial banking and investment trust functions, without regard to the issuance or nonissuance of voting permits.

Congressional recourse to the foregoing arrangement, in which Section 21 overlapped Sections 19 and 20 in part but also surpassed them in scope, is understandable. Congress was concerned that it might not have the constitutional power to assert its legislative authority to the full extent it wished. There was the risk that one or another Section of the Act might be held to exceed permissible constitutional limits. *See* S. Rep. No. 77, *supra,* at 10; 77 Cong. Rec. 4179 (remarks of Sen. Tydings) (1933). In that event, Congress did not want its legislative effort to go entirely for naught. The remaining provisions of Glass-Steagall presumably would ensure continued regulation of the banking industry.

In drafting Section 21 as a broad, comprehensive "catch-all" provision designed to round the corners of the complementary prohibitions contained in Glass-Steagall, Congress acted with foresight for the future. The modern one-bank holding company phenomenon generally has emerged from the creation of the holding company by the bank itself through the device of a "phantom merger." Typically the bank causes the

formation of its corporate parent and then passes its shares (often through merger with a third corporate entity of limited existence, specially formed for the purpose) to the parent while the parent's stock is distributed ratably among the bank's shareholders. *See, e.g., Banking,* vol. 41, 34 (Dec. 1968).[9] The Board's view that the holding company device lawfully may be used by a bank to circumvent the restrictions of Glass-Steagall Section 21 not only ignores economic realities, but is at odds with Congress' expressed objective of getting banks out of the securities issuing and marketing business.

The Board's refusal to consider the bank and its holding company as an economic unit for purposes of analysis under Section 21 contrasts tellingly with its other decisions under Glass-Steagall. The Board elsewhere has recognized the appropriateness of treating a holding company and its bank subsidiary as a single entity for purposes of Glass-Steagall Act Section 32. That provision, as noted above, prohibits officers, directors, and employees of any member bank from serving simultaneously in similar capacities with companies "primarily engaged in the issue, flotation, underwriting, public sale, or distribution . . . of . . . securities." In a 1969 case involving an interlocking relationship between a securities company and a bank holding company, the Board found:

> "[W]here the principal activity of a holding company is the ownership and control of banks, including one or more member banks, the holding company and each member bank subsidiary should be considered as constituting together a single entity

[9] Nine of the 10 banking institutions that sponsored the currently operating closed-end investment companies (see table, pp. 17-18 *supra*) are one-bank holding companies.

> for section 32 purposes, so that a person who is primarily engaged in section 32 business or associated with an organization so engaged is prohibited by that law from serving as an officer, director, or employee of such a holding company." 12 C.F.R. § 218.114(e); *see also id.* § 218.113.

The Board based its holding on the conclusion that to fail to apply the Section 32 restrictions to both the bank holding company and its subsidiaries would frustrate the objective of Congress:

> "[T]he affairs of the member bank and the holding company would be so closely identified and functionally related that the same possibilities of abuse which section 32 was designed to guard against would be present in the case of a director of the holding company as in the case of a director of the member bank . . . ." *Id.* § 218.114(d).

Similarly, in a 1963 decision, the Board found that Section 32 barred interlocking service as a bank director by an officer of a company that served as an investment adviser to two open-end investment funds, where it appeared that the adviser had been created for the purpose of serving the funds and stood in a close relationship of management and control over them. The Board concluded that notwithstanding their technically separate identities, the adviser and the fund must be regarded as the same entity. 12 C.F.R. § 218.-107.

The Board has applied the same rationale in response to a petition by the Securities Industry Association concerning the brokerage activities of Citicorp Person-to-Person Investments, Inc. ("CPPI") in connection with the sale of Citicorp notes. CPPI is a wholly owned subsidiary of Nationwide Financial Services Corpora-

tion, which itself is a wholly owned subsidiary of Citicorp, a bank holding company. The Board concluded that even if CPPI were itself engaged principally in activities that would violate Glass-Steagall Section 20, nonetheless the parent and subsidiary, viewed together, were not "principally" engaged in securities activities in violation of Section 20. Letter from Theodore E. Allison, Secretary of the Board, to Edward I. O'Brien, President, Securities Industry Association (Dec. 27, 1977). The Board found that CPPI was not "principally" engaged in securities activities because it constituted only a part of a holding company complex that in the aggregate was not principally engaged in securities activities in that it was engaged in banking activities.

Thus, contrary to its position now urged upon the Court, the Board has recognized that the application of both Sections 20 and 32 properly turns upon consideration of the bank holding company complex as a whole. The Board has not explained why the banking activities of a holding company complex similarly should not be imputed to a nonbanking subsidiary for purposes of enforcing the restrictions of Section 21.

B. The Absence of Bank Industry Sponsorship of Closed-End Investment Companies Demonstrates the Contemporaneous and Continuing Understanding of the Statutory Prohibition

The banking community well understood the significance of the Glass-Steagall Act insofar as its former association with securities marketing was concerned. Only after promulgation of the Regulation here under challenge did banking institutions—including banks as well as bank holding company affiliates—again involve themselves in the issuance and marketing of securities.

So far as can be determined from the publicly available materials, it appears that banks and their affiliates in the years immediately following the enactment of Glass-Steagall disappeared from securities marketing, with at most a handful of possible exceptions. According to a report prepared by the Securities and Exchange Commission staff in 1938, as of the end of 1935 there were no bank affiliates or commercial bank and trust companies involved in the sponsorship of open-end investment companies. *SEC Report on Investment Trusts and Investment Companies* (Part 2), H.R. Doc. No. 70, 76th Cong., 1st Sess. 59 (1939). As for bank involvement in closed-end companies, the SEC Report said:

> "[One of t]he most striking changes in the sponsorship of closed-end companies within the period 1929 and 1935 [was] . . . the disappearance of national bank security affiliates as sponsors *because of the abolition of such affiliates by the Banking Act of 1933.*" *Id.* (emphasis supplied).

See Camp, 401 U.S. at 629.

In its brief to the Court here, the Board points to a reference in the same SEC Report to the effect that as of the end of 1935, banks and trust companies were said to be the sponsors of some 12 closed-end companies. SEC Report at 58, *cited in* Pet. Br. 34 n.26, 55. The Board's reliance upon this passage is misplaced. The SEC Report admittedly used the term "sponsored" in a loose sense, acknowledging:

> "The term sponsor is generally used in this chapter to describe the organizer, the firm which was the originating banker for the securities of the investment company, or the dominant management group. For the purposes of this section, the apparent dominant management group was con-

> sidered the sponsor *because it was impossible in many cases to identify the original organizers of the companies.*" *Id.* at 56 (emphasis supplied).

The Board asserts that banking organizations continued to sponsor and organize closed-end investment companies following the enactment of Glass-Steagall (Pet. Br. 34 n.26, 55). That is not correct. The SEC Report makes clear that sponsorship of closed-end funds and sale of their securities practically ceased shortly after the 1929 market crash:

> "New capital in the investment company field from 1927 through 1929 was raised largely by the sale of securities of closed-end companies, that is, by closed-end management investment companies proper and management investment-holding companies. By far the largest number of closed-end management investment companies in existence at any time were organized prior to the end of 1929, and practically all of them were formed prior to the end of 1930. . . . *The sale of the securities of closed-end management investment companies* proper and management investment-holding companies *declined sharply in 1930 and practically ceased thereafter,* although at the end of 1936 these groups still possessed nearly 75% of the assets of the industry." SEC Report (Part 3), at 4 (footnotes omitted) (emphasis supplied).

In all likelihood, therefore, the 12 closed-end funds in existence in 1935, identified in the SEC Report as sponsored by commercial banks and trust companies and now pointed to by the Board (Pet. Br. 34 n.26, 55), were the same 12 funds that were in existence in 1929 and that were identified as sponsors at that time. In other words, those funds were sponsored at least three years *prior* to the Glass-Steagall prohibition.

Following the enactment of Glass-Steagall and the disappearance of bank-sponsored investment companies, broker-dealer sponsorship of such companies emerged as the primary source of such securities marketing activities. According to the SEC Report, *supra,*

> "By the end of 1935, open-end companies had $356,000,000 or 24% of the total assets of all management investment companies proper. *This rapid growth was characterized by the rise in the importance of brokers and dealers as sponsors of these companies.* At the end of 1935, this type of sponsor dominated 17 companies with total assets of $191,000,000 as compared with five companies with total assets of $37,000,000 at the end of 1929. Investment counsel, etc., who were the sponsors of 10 open-end companies at the end of 1929, over half of the then total number, were the sponsors of 15 such companies with total assets of $79,000,000 at the end of 1935. Of the remaining seven open-end companies, two were sponsored by houses of issue, two by individual capitalists and promoters, two by other sponsors, and one by mixed sponsors." *Id.* at 59 (emphasis supplied).

Thereafter, banking institutions remained separated from the investment company business, including their holding company affiliates, until the Board's adoption of the Regulation that is here under challenge. The continued absence of banking industry sponsorship of closed-end investment companies is reflected in the annual reports of Wiesenberger Investment Companies Service. Apart from the continued existence of such companies that had been organized by banking associations prior to the enactment of Glass-Steagall, the

Wiesenberger volumes are devoid of any suggestion of bank holding company sponsorship of investment companies, whether of the open- or closed-end variety, prior to the Board's 1971 Regulation.

A House Report published in 1955 contained a list of nonbanking organizations within the 18 holding company affiliate groups under regulation by the Federal Reserve Board as of 1953. H.R. Rep. No. 609, 84th Cong., 1st Sess. 10 (1955). Not one of the nonbanking organizations was an investment company. It could not have been shyness on the part of the bank holding companies that prevented them from setting up investment companies. As the court of appeals observed below, this is additional evidence that bank holding companies viewed the Glass-Steagall Act as prohibiting their involvement in the investment company business. 606 F.2d at 1017 n.32 (Pet. App. 29a).

Both the Board and its supporting *amici* rely on Section 10(c) of the Investment Company Act of 1940, 15 U.S.C. § 80a-10(c), as support for the proposition that closed-end investment companies were not barred from bank affiliation by Glass-Steagall (Pet. Br. 27-28 n.20; Am. Br. 28-30). Section 10(c) provides:

> "After the effective date of this title, no registered investment company shall have a majority of its board of directors consisting of persons who are officers or directors of any one bank: Provided, That, if on March 15, 1940, any registered investment company shall have had a majority of its directors consisting of persons who are directors, officers, or employees of any one bank, such registered company may continue to have the same percentage of its board of directors consisting of

> persons who are directors, officers, or employees of such bank."

That provision does not advance the Board's case. It does not *permit* interlocking directors between banks and investment companies. It *forbids* an investment company to have a majority of directors who are also officers or directors of any one bank. It leaves the law of interlocking directors where it was under Section 32 of the Glass-Steagall Act. It is an outer limit on the permissible number of interlocking directors between any one bank and an investment company, whether or not the investment company is engaged in *any* issuance of securities, and no matter what role the bank played in the creation of the investment company.

The grandfather clause of the provision does not condone involvement of an officer or director of a bank in the creation of an investment company. To the contrary, the legislative history of the provision makes clear that the clause was meant only to allow one or two interlocking directorates to continue:

> "[T]here are one or two such situations which are still left, and we recommended that they be not disturbed, but that the relationship should not be permitted to be created in the future." *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 76th Cong., 3d Sess. 886 (1940).

It appears that the situations allowed to continue included one or two of the 12 closed-end companies that still were advised by banks in 1935 according to the 1938 SEC Report. *See* p. 71 *supra.* As noted above,

it is likely that these 12 closed-end companies were sponsored prior to Glass-Steagall.

C. The Regulation Cannot Be Saved by the Restrictions Contained in the Board's Interpretive Ruling

In an effort to salvage the Regulation from its patent inconsistency with the prohibitions of Glass-Steagall, the Board issued an accompanying Interpretive Ruling. That Ruling does not save the Regulation from a determination of invalidity, but plainly concedes that the evils sought to be prevented by Glass-Steagall are inherent in the Regulation.

Having in effect acknowledged that deficiency, the Ruling attempts, without success, to preclude—evidently by administrative urgings rather than fiat—some, but far from all, of the evils that the Glass-Steagall legislation was intended to prevent. However, it is inevitable that the activities authorized by the Board will give rise to many of the same potential hazards, conflicts of interest, and unsound banking practices that Congress attempted to eliminate in Glass-Steagall.

First, a major danger noted by this Court in *Camp* was that "[t]he bank's stake in the investment fund might distort its credit decisions or lead to unsound loans to the companies in which the fund had invested." 401 U.S. at 637. The ultimate fee derived by the holding company affiliate in all likelihood will be a percentage of the value of the fund's portfolio assets, which in turn will depend on the financial health of the portfolio companies. As the court of appeals ob-

served below, that danger is equally present in the case of closed-end funds sponsored and managed by bank holding companies. 606 F.2d at 1023 (Pet. App. 45a-46a). The Interpretive Ruling does nothing to alleviate this evil.

Second, in a bank holding company-sponsored closed-end fund, no less than in the open-end fund declared unlawful in *Camp,* there is the danger that "[t]he bank might exploit its confidential relationship with its commercial and industrial creditors for the benefit of the fund." 401 U.S. at 637-38. For example, there is the risk that the subsidiary bank will disclose confidential information about its depositors to its affiliated investment adviser. 606 F.2d at 1023 (Pet. App. 45a). The Ruling leaves open the possibility of such abuse.

Third, a subtler danger perceived by the Court in *Camp* also applies with equal force to bank holding company-sponsored closed-end funds. The Court noted:

> "Imprudent or unsuccessful management of the bank's investment fund could bring about a perhaps unjustified loss of public confidence in the bank itself. If imprudent management should place the fund in distress, a bank might find itself under pressure to rescue the fund through measures inconsistent with sound banking." 401 U.S. at 637.

Along the same lines, the Court further observed:

> "If the fund investment should turn out badly there would be a danger that the bank would lose the good will of those customers who had invested in the fund. It might be unlikely that disenchantment would go so far as to threaten the solvency of the bank. But because banks are dependent on

> the confidence of their customers, the risk would not be unreal." *Id.* at 638.

A similar concern was expressed as part of the legislative background to the enactment of Glass-Steagall, when it was said:

> "The bank is closely connected in the public mind with its affiliates, and should the latter suffer large losses it is practically unthinkable that they would be allowed to fail." *Hearings Pursuant to S. Res. 71, supra* at 1063 (App. Part VII).

To be sure, the Board's Interpretive Ruling purports to prohibit closed-end investment funds from using names similar to those of their bank or bank-affiliated advisers. 12 C.F.R. § 225.125(f). But it is disingenuous to suggest that Congress' fundamental concern to avoid public identification of an investment company with its bank sponsor can be remedied by such a simplistic device as prohibiting the use of a common name. Equally effective means of associating a bank with a sponsored fund in the public's mind are not prohibited under the terms of the Board's Ruling, such as the judicious use of the bank's name in the fund's promotional literature.

As a practical matter, there can be little doubt that bank sponsorship is publicly known. This is especially true in the case of those funds where such sponsorship is openly acknowledged, or where the funds and the banking complexes that advise them use the same logos. The Institute submitted evidence to the Board that banking institutions purporting to sponsor closed-end funds pursuant to the Board's Ruling already had entered into agreements that licensed the use of their logos to the sponsored funds (R. 338-50). Moreover,

in every case the prospectus filed by closed-end funds with the SEC must disclose the facts and circumstances concerning the fund's investment adviser. Much of the promotional literature capitalizes heavily on the names and reputations of the sponsor banks, fulfilling the Court's prediction in *Camp* that a "bank that operated an investment fund would necessarily put its reputation and facilities squarely behind that fund and the investment opportunity that the fund offered." 401 U.S. at 637. Thus, the same danger of undermining public confidence in banking institutions that was perceived by this Court in *Camp* is present in the case of closed-end funds sponsored by bank holding companies.

Fourth, another danger noted by the Court in *Camp* was that a bank engaged in advising an investment fund could find it difficult to give disinterested investment advice:

> "A bank that operates an investment fund has a particular investment to sell. It is not a matter of indifference to the bank whether the customer buys an interest in the fund or makes some other investment. If its customers cannot be persuaded to invest in the bank's investment fund, the bank will lose their investment business and the fee which that business would have brought in." 401 U.S. at 636.

Along those lines, the Court foresaw the danger that "[t]he bank might divert talent and resources from its commercial banking operation to the promotion of the fund," or "might make loans to facilitate the purchase of interests in the fund." *Id.* at 638. As Senator Bulkley put it during the Glass-Steagall debates:

> "Obviously, the banker who has nothing to sell to his depositors is much better qualified to advise

> disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment of which the bank is to receive an originating profit or an underwriting profit *or a distribution profit or a trade profit or any combination of such profit.*" 75 Cong. Rec. 9912 (1932) (emphasis supplied).

Similar concerns were expressed on the floor of the House. *See* 77 Cong. Rec. 4028 (remarks of Rep. Fish) (1933).

These dangers also are present in the case of closed-end funds sponsored and controlled by bank holding companies, at the time of the initial sale and again upon any subsequent sale of fund shares. The bank member of a bank holding company complex sponsoring such a fund will be tempted to encourage customers seeking investment advice at the time of the fund's initial offering (or at the time of any subsequent offering) to buy into its holding company's investment company. The Justice Department expressed a like concern to the Board in its submission below (A. 15).

The bank has an obvious incentive to promote the success of the initial offering of the closed-end fund securities, both because of the public identification of the bank and its sponsored fund (and the consequent wedding of their good will and fortunes) and because the starting size of the fund will determine the baseline of the bank holding company's fees, which are tied to net asset value. The Board's Ruling, calling upon employees to abjure favoritism in their investment advice to bank customers, blinks at the reality of the situation.

A related concern was voiced in the legislative materials preceding enactment of Glass-Steagall, where it was pointed out that "in the case of a trust company or a bank with a trust department, the possession of a security affiliate may adversely affect the independence with which fiduciary activities are exercised." *Hearings Pursuant to S. Res. 71, supra* at 1034.

Finally, the Board's Regulation may lead to undesirable fluctuations in the value of the securities of the bank itself or of its holding company if publicly traded; also, to a tendency on the part of the bank to make unwise loan commitments in the knowledge that in case of need those commitments can be shifted to the investment company portfolio and thus removed from the bank's statement of condition. Significantly, concerns of this order, which are not addressed in the Board's Interpretive Ruling, were voiced nearly 50 years ago. *See Hearings Pursuant to S. Res. 71, supra.*

There can be no question that the challenged Regulation creates the potential for abuse. The Board has conceded that "potential conflicts of interest . . . may exist" as a result of the activities that it has authorized. 12 C.F.R. § 225.125(g). The Board may have sought to blunt such conflicts of interest by its Interpretive Ruling. But the restrictions there urged upon participants in the Board's securities program cannot mask the activities that have been, and will be, conducted under the aegis of its Regulation.

Of equal significance is the Board's studious disregard of the proper scope to be accorded the Glass-Steagall Act. The Board should strive to give full effect to Congress' intent, not to chip away at it. It is not the proper province of the Board to devise a regula-

tory regime that creates, rather than eliminates "potential conflicts of interest."

The Glass-Steagall Act as a whole should be followed with the thought that "[i]t is a preventive or prophylactic measure." *Board of Governors* v. *Agnew, supra,* 329 U.S. at 449 (discussion of Section 32); *cf. ICI* v. *Camp, supra,* 401 U.S. at 639. The legal restrictions of Glass-Steagall cannot be vitiated by the Board's adoption of rules for bank investment advisory activities that permit bank and bank affiliate sponsorship of closed-end investment companies. Absent congressional delegation of authority to the administrative agency, conduct made illegal by statute cannot be rendered lawful by the agency's issuance of regulations declaring the activity acceptable under certain circumstances. *See Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 213-14 (1976); *Dixon* v. *United States,* 381 U.S. 68, 75 (1965); *Manhattan General Equipment Co.* v. *Commissioner,* 297 U.S. 129, 134 (1936).

Contrary to the Board's present suggestion (Pet. Br. 5 n.7), it cannot automatically be assumed under the current statutory regime that involvement of the banking industry in the securities business will proceed under the watchful eye of competent regulatory authorities. Where the holding company proposes to proceed by the *de novo* establishment of a subsidiary investment company, no application to the Board is necessary; instead, the holding company may proceed simply by notice to an appropriate Federal Reserve bank, followed by a brief waiting and comment period. 12 C.F.R. § 225.4(b) (1980).

One may not assume with confidence that the Comptroller of the Currency and the Federal Reserve Board,

the principal federal regulatory agencies for banking institutions, have any expertise or authority in the securities area. The reason for their lack of familiarity with the subject is apparent. Congress never contemplated that banking institutions would be active in the investment company industry. As a result, important regulatory gaps undoubtedly will emerge if the banks are permitted to move into the area.

CONCLUSION

For the foregoing reasons, the Investment Company Institute, respondent herein, respectfully submits that the judgment of the court of appeals below should be affirmed.

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APPENDIX

APPENDIX A

Bank Sponsorship of Closed-End Investment Companies

Banks commenced advisory relationships with the following closed-end funds after the promulgation of the Board's Regulation and Ruling: Advance Investors Corporation—advised by First National City Bank (New York) (now "Citibank, N.A."); Ben Franklin Income Securities, Inc.—advised by Girard Trust Bank (Philadelphia); Bunker Hill Income Securities, Inc.—advised by Security Pacific National Bank (Los Angeles); Circle Income Shares, Inc.—advised by American Fletcher National Bank & Trust Company (Indianapolis); Excelsior Income Shares, Inc.—advised by a wholly-owned subsidiary of United States Trust Company of New York (New York); Fort Dearborn Income Securities, Inc.—advised by First National Bank of Chicago (Chicago); Hatteras Income Securities, Inc.—advised by North Carolina National Bank (Charlotte); Independence Income Securities, Inc.—advised by Provident National Bank (Philadelphia); Invesco Equity Fund, Inc.—advised by Citizens and Southern National Bank (Atlanta); Meridian Income Securities, Inc. —advised by Indiana National Bank (Indianapolis); Municipal Fund of America—advised by Provident National Bank (Philadelphia); Overland Income Securities, Inc.—advised by Wells Fargo Bank, National Association (San Francisco); Pacific American Income Shares, Inc.—advised by a wholly-owned subsidiary of United California Bank (Los Angeles); Temporary Investment Fund, Inc.—advised by Provident National Bank (Philadelphia); and Cardinal Income Securities, Inc.—advised by First Union National Bank of North Carolina (Charlotte). *See* R. 351-2169.

The SEC registrations of several of the above funds—including Ben Franklin Income Securities, Inc.; Hatteras Income Securities, Inc.; Meridian Income Securities, Inc.; Overland Income Securities, Inc.; and Cardinal Income

Securities, Inc.—were withdrawn or never became effective. However, the original registration statements entered into the administrative record for the investment companies no longer in existence demonstrate the pattern and nature of bank involvement in the securities industry purportedly pursuant to the challenged Regulation. Accordingly, they remain relevant to the issues presented here.

In some cases, bank sponsorship of closed-end investment companies was freely admitted.[1] Even where sponsorship was not expressly admitted, strong indicia of sponsorship point to the conclusion that the relevant closed-end funds in fact have been sponsored by their bank advisers. The record portrays banks actively engaged in the creation and sponsorship of stock funds, as well as arranging for the underwriting and public sale of the securities issued by those funds (R. 338-2169). In each case, the bank undertook the advisory relationship at the outset of the existence of the closed-end fund, before any fund securities issued or were offered for sale, and well before the commencement of fund operations. To facilitate the initial issuance and sale of the closed-end fund's securities, eight banks originally agreed to indemnify the underwriters participating in the sale of shares against certain liabilities under the Securities Act of 1933 (R. 373, 675, 950, 1071, 1123, 1465, 1547, 1864). All of the bank-advised closed-end funds made provision in their corporate documents for authorization of additional shares to be issued, and at least two

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[1] These include express admissions of sponsorship in Item 13 of the Form N-8B-1 filings of Overland Income Securities, Inc. (admitting sponsorship by Wells Fargo Bank, N.A.) and Excelsior Income Shares, Inc. (admitting sponsorship by wholly-owned subsidiary of United States Trust Company of New York). In the words of counsel who represented Citibank, adviser to Advance Investors Corporation (which originally was organized as a closed-end fund and subsequently converted into an open-end fund), "it is fair to say that Citibank participated in the initial sponsorship and organization of Advance" (R. 3099).

of those funds initiated such new issues (R. 2801-914). Additionally, most of the companies adopted some form of dividend reinvestment plan, whereby periodic dividends may be used for continuous purchases of additional shares of each company's stock (R. 369, 423, 486, 579, 669, 946, 1023). At least one bank undertook an advisory relationship to more than one closed-end fund (R. 1111-67, 1533-1600).

All the bank advisers of closed-end funds were empowered to manage the investment operations of the companies served. The banks not only were authorized to make the investment decisions, but also to place purchase and sale orders, select the broker-dealers, and perform a variety of other administrative functions. In almost all cases, extensive interlocking relationships proliferated between directors, officers, or employees of the closed-end fund and the adviser bank. The vast majority of officers and employees were common to both the adviser and the fund, as were a minority of fund directors in most cases (R. 364, 419-20, 482-83, 577-78, 667-68, 838, 943, 1028-29). In a number of instances, banks undertook to bear certain excess operating costs incurred by the funds (R. 365, 484, 575, 665, 840, 945). In at least one case, a bank agreed to bear the expenses of organizing and incorporating the fund (R. 664). In some cases, banks agreed to perform the functions of custodian or transfer agent or both for the funds (R. 372, 426, 846, 951).

In each case, of course, the bank was to be compensated for its service. Although the rates varied somewhat, the usual advisory fee provided for was 0.5 percent of the fund's net asset value, computed periodically (typically on a monthly basis). This procedure tied the advisory fee to the fund's performance. In the case of at least one fund—Peachtree Equity Securities, Inc.—this relationship was made even more explicit. Peachtree adopted an elaborate fee computation system under which the base fee payable to its ad-

viser (a wholly-owned subsidiary of a national bank) would increase or decrease in accordance with the performance of Peachtree's portfolio securities relative to the Standard & Poor's Index of 425 Stocks. Peachtree Equity Securities, Inc. technically constituted an open-end fund, as defined in Section 5(a)(1) of the Investment Company Act of 1940, 15 U.S.C. § 80a-5(a)(1), because its shares were redeemable at net asset value at any time.

Thus, the banks that commenced advisory relationships with closed-end funds after the promulgation of the Board's Regulation and Ruling plainly sponsored those funds.